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COVER NOTE

From:	Ivan Rogers, Permanent Representative, UK Representation to the EU
date of receipt:	15 October 2015
To:	Mr Carsten PILLATH, Director General, Council of the European Union
Subject:	United Kingdom: Report on Effective Action, as laid down in Article 3(4a) of Council Regulation (EC) 1467/97 on action taken by United Kingdom in response to the Council's recommendation under Article 126(7) TFEU.

Delegations will find attached the first part of the Report on Effective Action, as laid down in Article 3(4a) of Council Regulation (EC) 1467/97 on action taken by United Kingdom in response to the Council's recommendation under Article 126(7) TFEU.

UK Representation
to the EU Brussels

The Permanent Representative
Ambassador Ivan Rogers

Avenue d'Auderghem 10
1040 Brussels
Belgium

Tel.: +32 (2) 287 8271
Fax: + 32 (2) 287 8396
e-mail: ps.permrep@fco.gov.uk

Mr Carsten Pillath
Director General,
General Secretariat of the Council
Rue de la Loi, 175
B-1048
Brussels
Belgium

14 October 2015

Dear Mr. Pillath, Dear Carsten,

REPORT ON UK ACTION BASED ON THE COUNCIL EXCESSIVE DEFICIT PROCEDURE RECOMMENDATION

1. I am writing to update you on the UK Government's most recent fiscal plans in the context of the Council Recommendation of 19 June 2015 that the UK achieve a headline budget deficit (treaty deficit) lower than 3 per cent of GDP by 2016-17. The Council Recommendation established a deadline of 15 October 2015 for the UK to implement appropriate measures, if required, and, in accordance with Article 3(4a) of Council Regulation (EC) No. 1467/97, to report in detail to both the Council and the Commission on the fiscal strategy required in order to achieve the targets.

2. The requirements set out in the Corrective Arm of the Stability and Growth Pact (Article 3.4a of Regulation 1467/97 as amended) state that, following a new recommendation, Member States need to provide information on:
   a. Targets for government expenditure and revenue and for discretionary measures, on both the expenditure and revenue side consistent with the Council's recommendation.
   b. Information on the measures taken and the nature of those envisaged to achieve the targets.

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3. The new Government set out its fiscal plans in the Summer Budget on 8 July 2015. This letter, which I am jointly sending to Mr Marco Buti (DG, Economic and Financial Affairs, European Commission), accompanies a copy of the 2015 Summer Budget and the independent Office for Budget Responsibility's (OBR) Economic and Fiscal Outlook, and highlights the information in the Budget that is pertinent for the targets in the recommendation. I address each element of the EDP recommendation in turn:

End the present excessive deficit situation by 2016-2017.

4. The recommendation makes clear that to reach the targets set, "the UK needs to fully implement, in a timely manner, the measures announced up to and including the 2015 budget (March), with any modifications in relation to the current plans being fiscally neutral; in that case, no further measures on top of those already announced will be needed."

5. Following the Summer Budget, the UK remains on course to meet the Recommendation set by the Council in June to put an end to the present excessive deficit situation by 2016-2017. The OBR forecasts a UK treaty deficit of 2.3% GDP in 2016-17.

   This is underpinned by the UK's commitment, set out by the Chancellor in his Summer Budget, to eliminate the deficit. The Government will introduce new fiscal rules to: achieve an overall surplus in 2019-20; for the debt to GDP ratio to be falling in every year to 2019-20; and, embed the requirement for governments to run surpluses in normal times. Running a surplus is the most reliable way to reduce the debt-to-GDP ratio in the long term.

6. The attached Summer Budget provides an overview of consolidation plans over this Parliament to reach a surplus in 2019-20 (Table 1.5 on page 20). In addition to significant in-year savings announced in June, about half of the measures required to eliminate the deficit are detailed in the Summer Budget. This comprises £12 billion savings from welfare reform and £5 billion savings generated by reforms to the tax system which are intended to tackle tax avoidance and tax planning, evasion and non-compliance, and imbalances in the tax system. The remaining measures will be identified after rigorous examination in the Spending Review/Autumn Statement process, which the Chancellor will present to Parliament on 25 November 2015. We will confirm our commitment to increase spending on the NHS and ensuring that 2 per cent of GDP is allocated to defence spending.

7. These consolidation measures will be made smoothly over the current parliament, with £6 billion of consolidation by 2016-17 already detailed in the Summer Budget. This comprises approximately £5 billion of savings through welfare reform as well as over £1 billion of measures addressing avoidance and tax planning, evasion and compliance, and imbalances in the tax system. These measures are explained in detail in Section 2 of the attached Summer Budget (pages 71 – 98), as are the numerical impacts each measure is forecast to have on consolidation (Table 2.1 on pages 72 – 74).

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8. The welfare reform measures that are forecast to have the greatest impact on reducing the 2016-17 deficit are reforms to tax credits and Universal Credit. We expect that increasing the tax credits taper rate to 48 per cent will reduce spending by £1.5 billion, while reducing income thresholds in tax credits and work allowances in Universal Credit will save a further £2.9 billion. Further announced changes to welfare reform include: changes to the welfare cap; further changes to tax credits and Universal Credit (including reducing the income rise disregard in tax credits); and changes to housing benefits (such as a reduction of social sector rents by 1 per cent each year from 2016-17 onwards). The net sum of these changes is an improvement of £5.0 billion in the government's preferred measure of the 2016-17 budget deficit, Public Sector Net Borrowing (Table 2.1 on page 74).

9. Increasing the Insurance Premium Tax from 6 per cent to 9.5 per cent is expected to increase receipts by a further £1.5 billion. Further announced measures include: addressing imbalances in the tax system (including equal treatment for generators under the Climate Change Levy); addressing avoidance and tax planning (such as tackling avoidance by hedge funds and private equity firms); preventing evasion (for example, increased compliance from large businesses); and promoting compliance (tackling illicit alchohol and tobacco). The net sum of all these changes is an improvement of £1.3 billion in 2016-17 Public Sector Net Borrowing (Table 2.1 on page 74).

Reach a headline deficit (treaty deficit) of 4.1 per cent of GDP in 2015-2016 and 2.7 per cent GDP in 2016-2017.

10. The Summer Budget set out a strategy to smooth the path to the overall surplus in 2019-20, maintaining the same average pace of reduction in the headline measure of Public Sector Net Borrowing in this Parliament as in the last. Against EDP targets for the headline budget deficit (treaty deficit) of 4.1 per cent in 2015-16 and 2.7 per cent in 2016-17, the independent OBR forecast published alongside the Summer Budget projects the 2015-16 deficit at 4.0 per cent and the 2016-17 deficit at 2.3 per cent of GDP (see table 4.31 on page 156 of the OBR Economic and Fiscal Outlook). The UK's fiscal plans therefore remain consistent with the target in the recommendations to bring an end to the excessive deficit situation by 2016-17. The OBR will publish a new forecast alongside the Spending Review and Autumn statement next month.

Table 1- UK Performance against EDP headline deficit (treaty deficit) Recommendation Post Summer Budget

Measure		EDP target	EU Spring forecast	OBR July forecast
Headline Deficit	2015-16	4.1%	4.1%	4.0%
	2016-17	2.7%	2.7%	2.3%

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Improvement in the structural balance of 0.5 per cent of GDP in 2015-2016 and 1.1 per cent of GDP in 2016-2017

11. Turning to the structural deficit, the Summer Budget forecast shows an improvement in the structural balance of 0.7 per cent in 2015-16 and a further improvement in the structural balance of 1.5 per cent in 2016-17 (see Table 2 below, or Table 1.6 on Page 23 of the attached Budget document).

Table 2: UK Performance against EDP structural adjustment Recommendation Post July

Measure		EDP Target	EU Spring forecast	OBR July forecast
Structural adjustment	**2015-16**	0.5%	0.5%	0.7%
	2016-17	1.1%	1.0%	1.5%

Implement all previously announced measures, with any modifications being fiscally-neutral in relation to the current plans

12. The Summer Budget sets out a smoother fiscal path, leading to a lower public sector net debt as a share of GDP and a higher surplus in 2019-20, relative to the March Budget. The recommendation also states that the UK should further detail planned expenditure cuts in the upcoming Spending Review. The current Spending Review is ongoing and the Government will publish the results on 25 November, alongside the Chancellor's Autumn Statement.

The UK should accelerate the reduction of the headline deficit in 2015-2016 and 2016-2017 if economic, financial or budgetary conditions turn out better than currently expected.

13. The UK Government plans to reduce the headline deficit (treaty deficit) over 2015-16 and 2016-17 at an appropriate rate, as set out in the targets above. The Government is continually monitoring developments in the global economy closely and their impact on the public finances. The recommendation also states that further cuts in capital expenditure should be avoided. The Government will set out its capital expenditure plans in the forthcoming Spending Review. This will enable us to achieve the Council's recommendation in a way that is consistent with the current government's targets of decreasing debt-to-GDP over each of the next five years and running a surplus in 2019-20.

14. The attached 2015 Summer Budget and the Office for Budget Responsibility's Economic and Fiscal Outlook provide further background on our fiscal measures over the medium term.

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15. My team in the Permanent Representation, and colleagues at HM Treasury, stand ready to answer any questions you may have in relation to the UK's fisal policy.

Yours,

Ivan Rogers.

IVAN ROGERS

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Annex 1: Council Recommendation (EU) 2015/1029 of 19 June 2015

(1) The United Kingdom should put an end to the present excessive deficit situation by 2016-2017 at the latest.

(2) The United Kingdom should reach a headline deficit of 4,1 % of GDP in 2015-2016 and 2,7 % of GDP in 2016-2017, which should be consistent with delivering an improvement in the structural balance of 0,5 % of GDP in 2015-2016 and 1,1 % of GDP in 2016-2017, based on the Commission's updated 2015 spring forecast.

(3) The United Kingdom should fully implement the consolidation measures incorporated into all budgets and autumn statements up to and including the 2015 budget to achieve the recommended structural effort, with any modifications being fiscally-neutral in relation to the current plans. The United Kingdom should further detail the expenditure cuts in the upcoming Spending Review. These are necessary to ensure the correction of the excessive deficit by 2016-2017.

(4) The United Kingdom should accelerate the reduction of the headline deficit in 2015-2016 and 2016-2017 if economic, financial or budgetary conditions turn out better than currently expected. Budgetary consolidation measures should secure a lasting improvement in the general government structural balance in a growth-friendly manner. In particular, further cuts in capital expenditure should be avoided.

(5) The Council sets the deadline of 15 October 2015 for the United Kingdom to (i) take effective action; and (ii) in accordance with Article 3(4a) of Regulation (EC) No 1467/97 to report in detail the consolidation strategy that is envisaged to achieve the targets.

Furthermore, the UK authorities should (i) comply with the obligation to set out a medium-term budgetary objective as laid down in the Stability and Growth Pact; and (ii) implement the planned reforms of increasing the state pension age in order to contribute towards strengthening the long-term sustainability of the public finances.

Finally, to ensure the success of the fiscal consolidation strategy, it will also be important to back the fiscal consolidation by comprehensive structural reforms, in line with the Council Recommendations addressed to the United Kingdom in the context of the European Semester and in particular those related to the preventive arm of the Macroeconomic Imbalances Procedure.

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HM Treasury

SUMMER BUDGET 2015

HC 264

July 2015

HM Treasury

SUMMER BUDGET 2015

Return to an order of the House of Commons
dated 8 July 2015

Copy of the Summer Budget Report – July
2015 as laid before the House of Commons
by the Chancellor of the Exchequer when
opening the Budget.

David Gauke
Her Majesty's Treasury
8 July 2015

Ordered by the House of Commons to be
printed 8 July 2015

HC 264

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The Budget report is presented pursuant to section 2 of the Budget Responsibility and National Audit Act 2011 and in accordance with the Charter for Budget Responsibility. The Budget report, combined with the Office for Budget Responsibility's Economic and fiscal outlook, will constitute part of the government's assessment under section 5 of the European Communities (Amendment) Act 1993 that will form the basis of the government's submissions to the European Commission under 121 TFEU (ex Articles 99/103 TEU) and Article 126 TFEU (ex Article 104/104c TEU) after the assessment is approved by Parliament.

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Summer Budget 2015

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Executive Summary

This is a Budget that puts security first. It ensures economic security for working people by putting the public finances in order and setting out a bold plan for a more productive, balanced economy. It supports national security by investment in defence. It sets out bold reforms on tax and welfare, and introduces a National Living Wage so we move Britain from a low wage, high tax, high welfare economy to a higher wage, lower tax, lower welfare economy. It delivers on the promises on which the government was elected.

Since 2010, the government has pursued a long-term economic plan that has halved the deficit as a share of GDP. For the first time since 2001-02, the national debt is falling in 2015-16, meeting the target set out in 2010. The UK was the fastest growing G7 economy in 2014, employment has reached record levels, and wages are rising above inflation.

But the job is not yet done. At 4.9%, the deficit remains too high, and productivity remains too low. The economy is still too unbalanced, and more needs to be done to build up the nations and regions of the UK, and to close the productivity gap between the north and south. The welfare bill is too high, and the welfare system traps too many people in benefit dependency. And for too long, the government has addressed low pay by subsidising it through the tax credit system, instead of delivering lower business taxes and asking business to pay higher wages.

This Budget sets out the action the government will take to:

- eliminate the deficit and run an overall surplus to start paying down debt, while increasing spending on defence and the NHS
- reward work and back aspiration, by introducing a new National Living Wage, cutting taxes so people can keep more of what they earn, and reforming the welfare system to make it more affordable and fair to the taxpayers who pay for it
- back business and make the economy more productive, by cutting corporation tax and increasing the permanent level of the Annual Investment Allowance, and by undertaking major reform of funding for skills and infrastructure to ensure higher standards of living for everyone in the UK
- secure a truly national recovery, by devolving powers and budgets to build a Northern Powerhouse, and create the right conditions for strong growth throughout the UK

Fixing the public finances and running a surplus

The government's long-term economic plan has laid the foundations for a stronger economy, and the UK's recovery is now well established. The labour market remains strong, and in the 3 months to April 2015, employment was around record levels at 31.1 million.

Earnings growth is continuing to strengthen, with earnings up 2.7% over the year in the 3 months to April 2015. Living standards are forecast to be higher in 2015 than they were in 2010, and are expected to continue to grow over the forecast period.

However, Britain is still running a 4.9% deficit, and debt is above 80% of GDP. As seen in recent weeks, the risks from abroad, not least within the euro area, demonstrate the need to secure the UK's economic recovery.

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The government will continue to reduce the deficit by around 1.1% of GDP a year on average, the same pace as over the last Parliament. This fiscal path means that the deficit falls smoothly, and that debt falls as a share of GDP in every year of the Parliament. At the same time, the government will ensure that the UK spends 2% of GDP a year on defence for the rest of the decade, and that spending on the NHS in England increases by £10 billion per annum in real terms by 2020-21. As a result of this plan, a surplus will be achieved in 2019-20, and debt as a share of GDP in that year is forecast to be lower than expected at March Budget 2015. New fiscal rules will cement this fiscal path, and ensure that governments run surpluses in normal times.

To achieve the surplus in 2019-20 the government will undertake around £37 billion of further consolidation measures. This Budget sets out around £17 billion of measures that will reduce the deficit, including £12 billion by 2019-20 from welfare reform and £5 billion by 2019-20 from tackling tax avoidance and tax planning, evasion and compliance, and imbalances in the tax system. In the autumn, the government will set out plans to deliver the remaining £20 billion of consolidation measures required to achieve the surplus following a rigorous Spending Review process.

Economic forecast

The Office for Budget Responsibility (OBR) forecasts GDP growth of 2.4% in 2015, 2.3% in 2016, and 2.4% for the remainder of the forecast period.

The OBR forecasts employment to be 31.2 million in 2015, rising each year to 32.1 million in 2020.

CPI inflation is forecast to be below target in 2015, returning gradually to 2.0% in 2020.

Fiscal forecast

Public sector net borrowing is forecast to fall to 3.7% GDP in 2015-16 and then to fall each year. The OBR forecasts that the public finances will return a surplus of £10 billion in 2019-20.

Public sector net debt is forecast to peak at 80.8% of GDP in 2014-19, before falling each year and reaching 68.5% of GDP in 2020-21.

Rewarding work and supporting aspiration

Underpinning the government's approach is a commitment to reward work and support aspiration. This Budget ensures that the welfare system is fair to taxpayers while supporting the most vulnerable, and builds an economy based on higher pay, lower taxes and lower welfare. It ensures that the richest are paying a greater share of tax than they were at the start of the last Parliament, whilst the poorest continue to receive the bigger share of spending.

This Budget:

- introduces a new National Living Wage for workers aged 25 and above, and asks the Low Pay Commission to set out how it will reach 60% of median earnings by 2020; based on OBR forecasts, this means that the National Living Wage will reach the government's target of over £9 by 2020
- reduces taxes on working people by further increasing the personal allowance to £11,000 in 2016-17 and the higher rate threshold to £43,000; as a result of increases to the personal allowance announced since 2010, a typical basic rate taxpayer will be £905 better off

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- confirms that, from September 2017, free childcare entitlement will be doubled from 15 hours to 30 hours a week for working parents of 3 and 4 year olds
- sets out the next stage of welfare reform, delivering on the government's commitment to save £12 billion from the working-age welfare budget by 2019-20, including by freezing working-age benefits and Local Housing Allowances for 4 years, reducing rents in social housing by 1% a year for 4 years, reducing the benefit cap, and reforming tax credits and Universal Credit with support focussed on those with lower incomes
- reforms the taxation of dividends by replacing the Dividend Tax Credit with a Dividend Tax Allowance of £5,000 and setting new dividends tax rates
- takes the family home out of inheritance tax for all but the wealthiest with a new transferable nil-rate band of up to £175,000 per estate when a main residence is passed to direct descendants; this means that the effective inheritance tax threshold will be £1 million
- pays for this by introducing a taper to the annual allowance for pensions tax relief for those with total income over £150,000
- increases the standard rate of insurance premium tax from 6% to 9.5%, and extends the time before a car needs its first MOT test from 3 years to 4
- restricts relief for mortgage interest for individual landlords to the basic rate of income tax, phased in over 4 years, limiting the advantage that these individuals currently enjoy over those purchasing their own home
- ends the permanent non-domicile status
- tackles tax evasion, avoidance and tax planning, increases tax compliance, and addresses imbalances in the tax system

Backing business and improving productivity

The best way to create jobs and raise living standards over the long term is to support business and increase productivity by making it more competitive and by prioritising investment in skills and infrastructure. This Budget sets out a plan to back business and support productivity by:

- cutting the corporation tax rate further to 19% in 2017 and 18% in 2020, benefitting over 1 million businesses, large and small
- setting the level of the Annual Investment Allowance to £200,000 from January 2016, its highest ever permanent level
- raising the Employment Allowance by £1,000 to £3,000 from April 2016 to support small businesses and charities to create jobs
- introducing a levy on large employers to fund 3 million new, high quality apprenticeships this Parliament
- supporting sustainable investment in universities by turning maintenance grants into loans, saving £2.5 billion by 2020-21
- reforming vehicle excise duty for new cars and hypothecating the revenue from 2020 to a Roads Fund to ensure sustained investment in the strategic road network

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Ensuring a truly national recovery

The government believes that the only way to secure a truly national recovery is through a fundamental rebalancing of the British economy based on investment across the regions, growth driven by the private sector, and further devolution to increase local decision making.

The government is:

- delivering on its commitment to devolve further powers to Scotland, Wales and Northern Ireland, introducing the Scotland Bill, and commencing discussions on a revised Scottish fiscal framework
- building strong city regions by devolving further powers to Greater Manchester and working towards devolution deals with the Sheffield City Region, Liverpool City Region, and Leeds, West Yorkshire and partner authorities as part of building a Northern Powerhouse
- supporting private-sector-led growth, and delivering on the long-term economic plans for the regions by continuing to invest in transport, science and skills

Budget decisions

A summary of the fiscal impact of Budget policy decisions is set out in Table 1. Chapter 2 provides further information on the fiscal impact of the Budget.

Table 1: Summary of Budget policy decisions[1]

	£ million					
	2015-16	**2016-17**	**2017-18**	**2018-19**	**2019-20**	**2020-21**
Total spending policy decisions	+2,590	+5,095	+5,945	+8,270	+11,280	+12,415
Total tax policy decisions	+980	+3,980	+5,090	+6,825	+5,785	+6,470
TOTAL POLICY DECISIONS	**+3,570**	**+9,075**	**+11,035**	**+15,095**	**+17,065**	**+18,885**

[1] Costings reflect the OBR's latest economic and fiscal determinants.

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Government spending and revenue

Chart 1 shows public spending by main function. Total Managed Expenditure is expected to be around £742 billion in 2015-16.

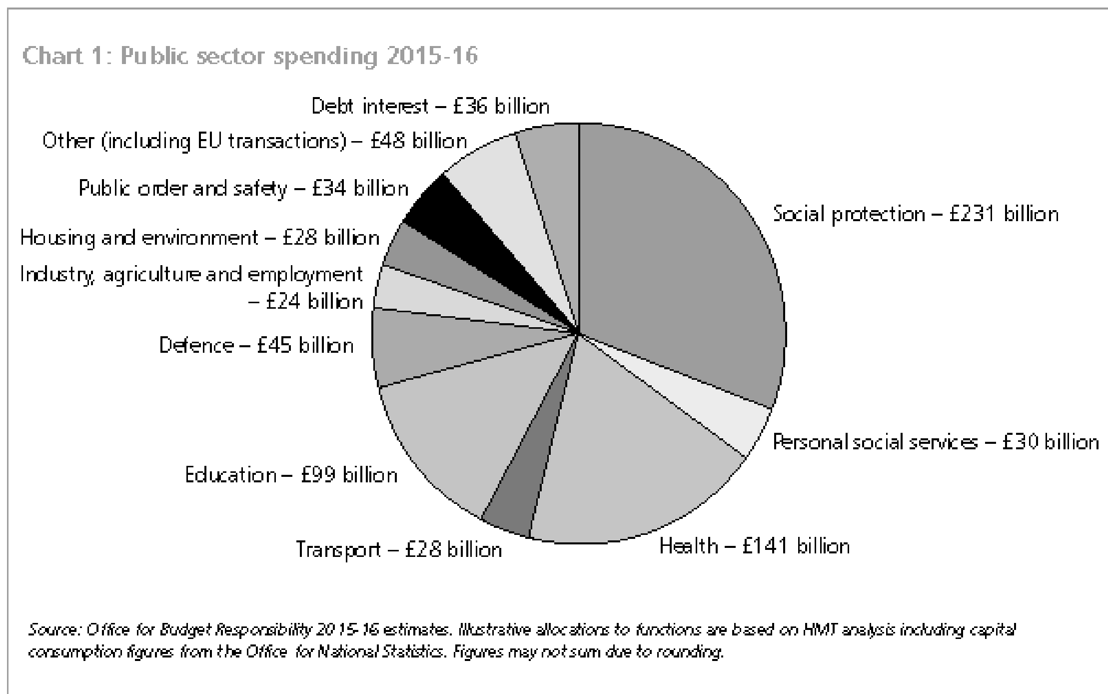

Chart 1: Public sector spending 2015-16

Source: Office for Budget Responsibility 2015-16 estimates. Illustrative allocations to functions are based on HMT analysis including capital consumption figures from the Office for National Statistics. Figures may not sum due to rounding.

Chart 2 shows the different sources of government revenue. Public sector current receipts are expected to be around £673 billion in 2015-16.

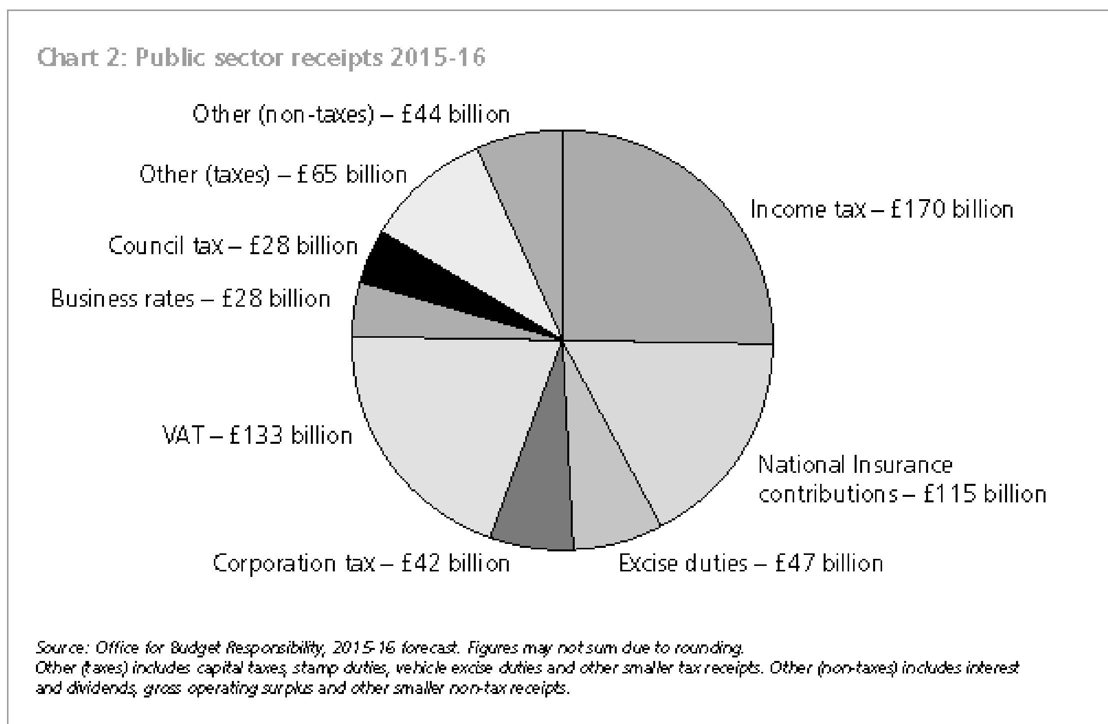

Chart 2: Public sector receipts 2015-16

Source: Office for Budget Responsibility, 2015-16 forecast. Figures may not sum due to rounding.
Other (taxes) includes capital taxes, stamp duties, vehicle excise duties and other smaller tax receipts. Other (non-taxes) includes interest and dividends, gross operating surplus and other smaller non-tax receipts.

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6 Summer Budget 2015

Budget Report

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1

Budget Report

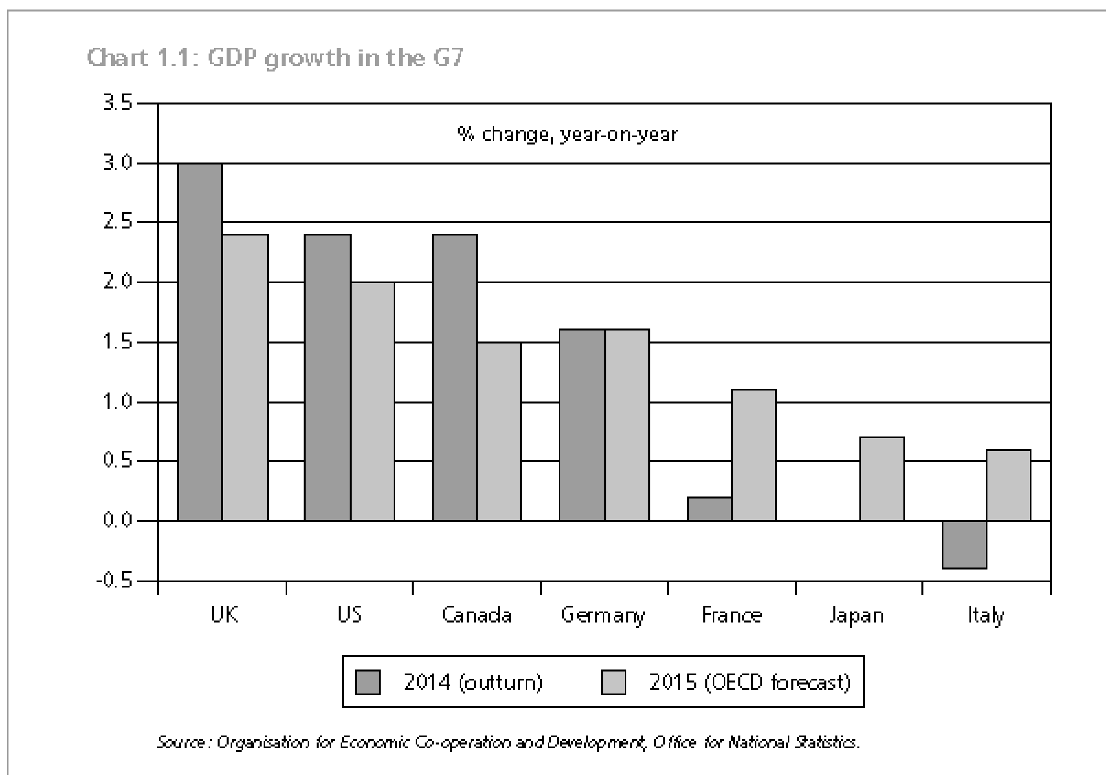
The UK economy and public finances

UK economy

1.1 The government's long-term economic plan has secured the recovery. The government's fiscal responsibility has allowed monetary activism to support demand in the economy alongside repair of the financial sector. This has been supported by supply-side reform to deliver sustainable increases in standards of living.

1.2 The UK's economic recovery is well established. The UK was the fastest growing G7 economy in 2014 growing by 3.0%, its best performance since 2006.[1] The Organisation for Economic Co-operation and Development (OECD) forecasts the UK to be the fastest growing G7 economy again in 2015, as shown in Chart 1.1.[2] Christine Lagarde, Managing Director of the International Monetary Fund (IMF), said "when we look at the comparative growth rates delivered by various countries in Europe it's obvious that what is happening in the U.K. has actually worked".[3]

Chart 1.1: GDP growth in the G7



Source: Organisation for Economic Co-operation and Development, Office for National Statistics.

[1] All UK economy data from Office for National Statistics (ONS) unless otherwise stated. Further detail can be found in 'Summer Budget 2015 Data Sources'.
[2] 'OECD Economic Outlook', Organisation for Economic Co-operation and Development (OECD), June 2015.
[3] Christine Lagarde, International Monetary Fund (IMF) Spring Meetings press conference, April 2015.

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1.3 The government's long-term economic plan has laid solid foundations for a stronger economy. This Budget continues the work of repairing the public finances, addressing the long-standing weakness in productivity and rebalancing the economy. It recognises the risks from abroad and the need to secure Britain's economic future.

Employment and earnings

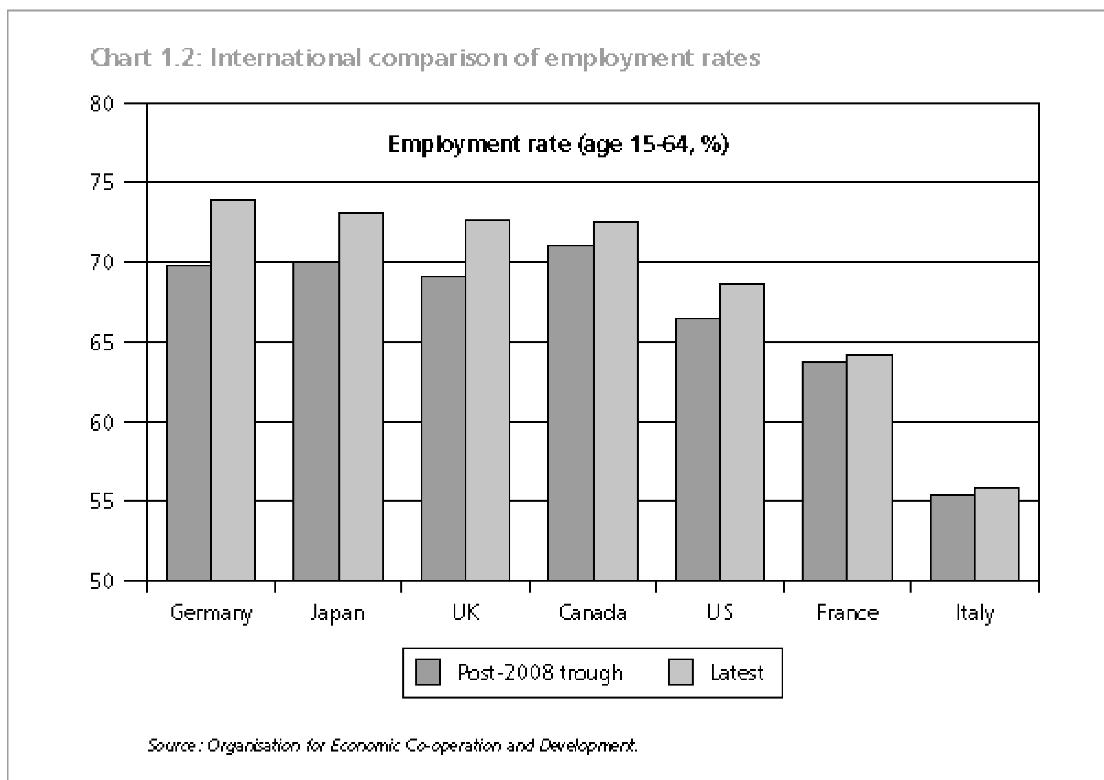
Employment

1.4 The UK labour market performance continues to be strong. In the 3 months to April the employment level and rate were both around record levels at 31.1 million and 73.4% respectively. The recent growth in employment predominantly reflects increases in full-time employment and those employed in high and medium-skilled occupations. Over the past year, 85% of the increase in employment has been in full-time work and 92% has been in high or medium-skilled jobs.[4]

1.5 The proportion of those who are inactive has been falling and is lower than it was before the crisis, but there are still too many working-age people who are not engaged in the labour force. Encouragingly, the increase in participation has been strong amongst women and older workers. The number of working-age women participating in the labour force has increased by over 700,000 since the beginning of the crisis. In the past year alone there have been an extra 200,000 workers aged over 50 in the labour force.

1.6 The UK's labour market has stood out among major advanced economies. Since the trough in the recession, the UK's increase in employment rate has been the second largest in the G7 behind only Germany.[5] The UK has taken another step towards achieving the government's full-employment ambition to have the highest employment rate in the G7, having overtaken Canada in Q1 2015 to have the third highest employment rate in the G7, behind Japan and Germany, as shown in Chart 1.2.

Chart 1.2: International comparison of employment rates



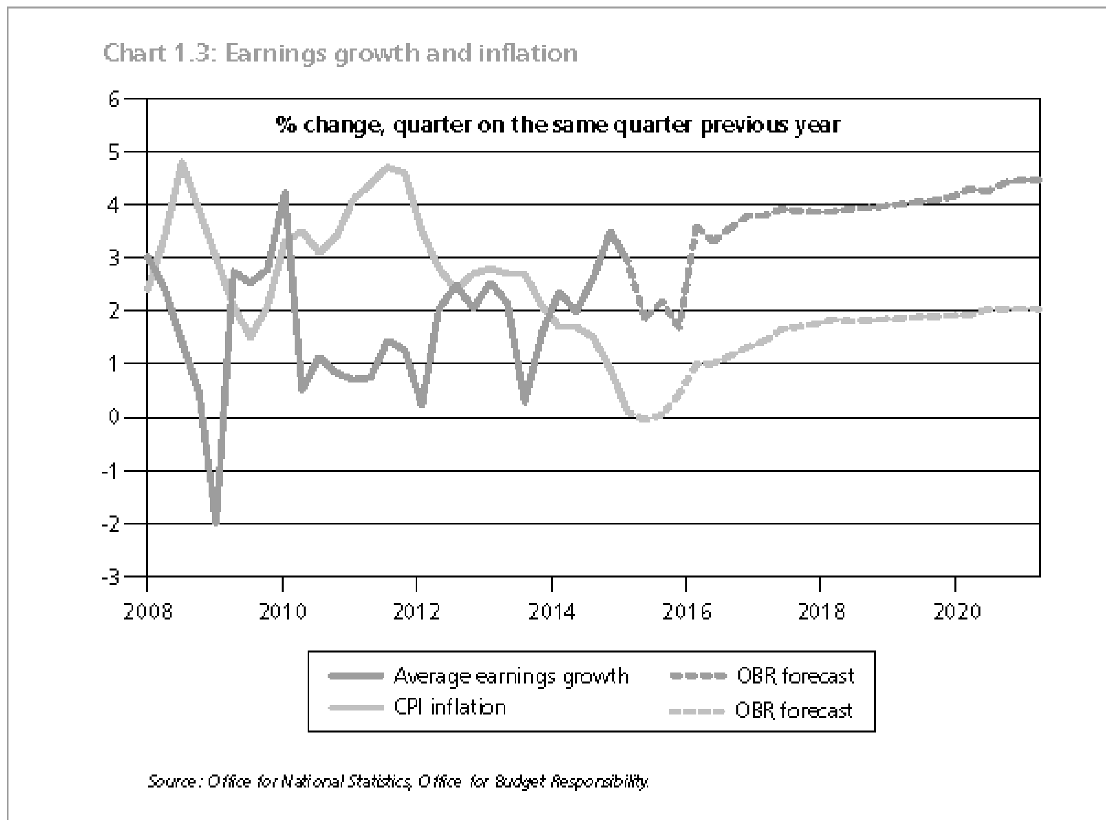
Source: Organisation for Economic Co-operation and Development.

[4] High and medium-skilled occupations as defined in 'Economic Review', ONS, December 2014.
[5] 'Short-Term Labour Market Statistics', OECD, June 2015.

Earnings

1.7 Earnings growth is continuing to strengthen with earnings up 2.7% over the year in the 3 months to April, the fastest growth in real wages since 2007. The OBR forecasts earnings to continue to rise above inflation over the forecast period, as shown in Chart 1.3.[6] The low inflation recently experienced in the UK, driven by lower fuel and food costs, has helped support real incomes and household budgets. Compared to May 2014, fuel and food prices are 11.0% and 1.8% lower respectively.

Chart 1.3: Earnings growth and inflation



Source: Office for National Statistics, Office for Budget Responsibility.

1.8 Real Household Disposable Income (RHDI) per capita is the most up to date and comprehensive measure of living standards as it takes into account employment levels, the effects of tax and benefits, as well as inflation. Living standards, as measured by RHDI per capita, are forecast to be higher in 2015 than they were in 2010 and to continue to grow over the forecast period.

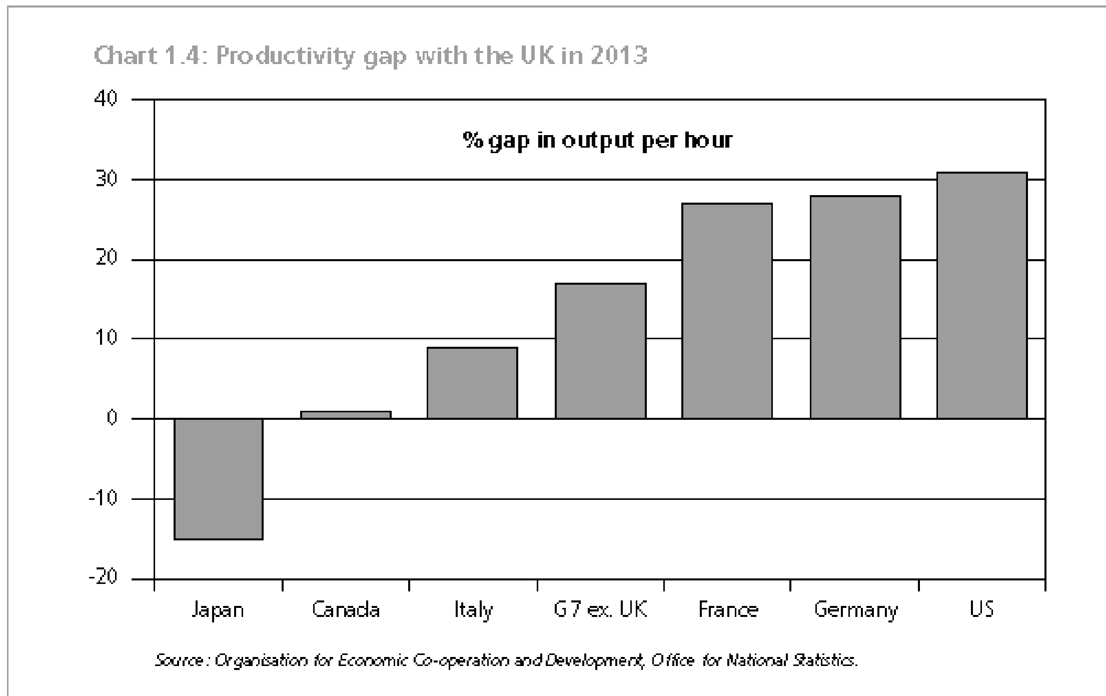
The UK's productivity challenge

1.9 A sustained improvement in productivity growth is critical to delivering the OBR's forecast for the economy. It is also the single most important determinant of average living standards and is tightly linked to the differences in wages across countries.

1.10 A large and long-standing productivity gap exists between the UK and other major advanced economies. Output per hour in the UK was 17 percentage points below the G7 average, 27 percentage points below France, 28 percentage points below Germany and 31 percentage points below the US in 2013, as shown in Chart 1.4.[7] This gap existed prior to the financial crisis but, whilst the UK has not been alone in having weak productivity growth

[6] All forecasts refer to the Office for Budget Responsibility (OBR) 'Economic and fiscal outlook', July 2015, unless otherwise stated.
[7] 'International Comparisons of Productivity – Final Estimates, 2013', ONS, February 2015.

since the financial crisis and there are issues around the data, it is clear this gap has widened.[8] The recent weakness in productivity growth has also occurred alongside strong employment growth in the UK.



1.11 The government is committed to reforming the UK economy to make it more productive. The government is publishing a productivity plan which tackles the UK's serious long-term challenges, with major reforms to improve the UK's infrastructure, tackle failures in the skills system, improve the planning system, encourage long-term finance for productive investment and give cities the governance and powers they need to succeed. Further information on the government's plan to support productivity is set out below, in 'Backing business and improving productivity'.

Rebalancing the UK economy

Regional rebalancing

1.12 London is one of the world's greatest global cities and a huge asset for the national economy, but in recent decades the UK has relied too heavily on the capital to generate growth. The UK's continued national prosperity depends on regions and cities outside the capital doing well. The government has a comprehensive plan to rebalance the economy and strengthen every part of the UK, bringing together the great cities and counties of the north of England, and supporting other vital regional economies such as the Midlands and South West.

1.13 Since 2010 unemployment has fallen in every region and almost two-thirds of the UK-wide increase in private sector employment can be attributed to regions outside London and the South East. Output per head in the North West, North East, West Midlands and Wales grew faster than in London in 2013. The government will go further by supporting the resurgence of strong metro-wide areas through devolution, enabling cities to work together to take responsibility for their own economic success by the creation of an elected mayor. Further information on the government's plan is set out below, in 'Ensuring a truly national recovery'.

[8] 'International Comparisons of Productivity – Final Estimates, 2013', ONS, February 2015.

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Sector rebalancing

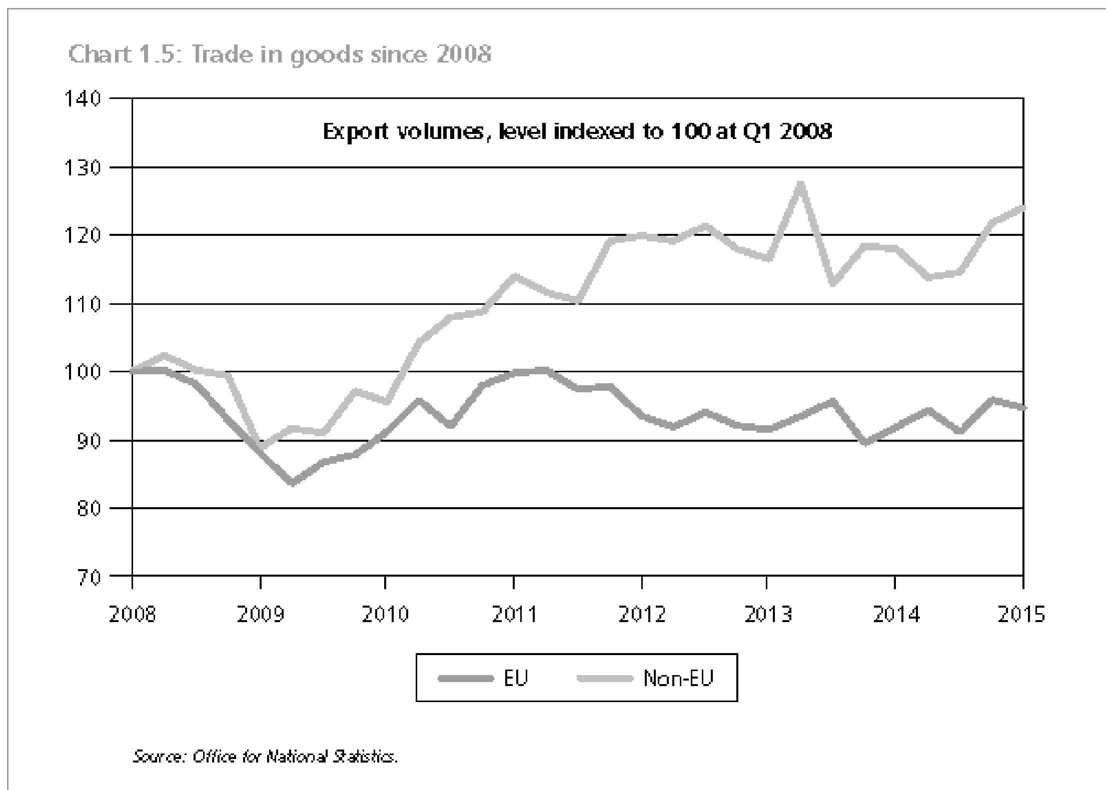
1.14 As the recovery has become established, growth has been more broadly balanced across sectors. There has been widespread growth across all major sectors since the start of 2013. Manufacturing, construction and services all grew by 3% or more in 2014, the first time since records began in 1990.

1.15 After falling during the crisis, recent UK growth has been more investment rich with business investment increasing as share of GDP. Real business investment has increased from 9.0% of GDP in 2010 to 10.6% of GDP in 2014 and is forecast to continue to do so. However, total investment as a share of output in 2014 was still lower in the UK than all other major advanced economies except Italy.[9] This is addressed in the productivity plan which will set out measures to encourage long-term investment in economic capital, including infrastructure, skills and knowledge.

External rebalancing

1.16 The UK is one of the most open economies in the world, with significant trade and financial links with other countries. Weak euro area growth has meant goods exports to EU countries have been subdued, falling by 5.3% since Q1 2008. However UK exports have continued to expand in other markets, as shown in Chart 1.5. The volume of goods exports to outside of the EU has increased by 24.1% since Q1 2008. The value of goods exports to the faster growing BRIC (Brazil, Russia, India, and China) economies has increased by 25.1% since Q1 2008.

Chart 1.5: Trade in goods since 2008



Source: Office for National Statistics.

1.17 The UK's trade balance as a share of GDP has improved slightly from -2.4% in 2010, to -2.0% in 2014 and is expected to improve further in 2015. The OBR's forecast for exports and imports over the forecast period reflects the slowdown in global trade volumes that has been seen since the early 2000s.[10] For any level of world GDP, world trade is now expected to be

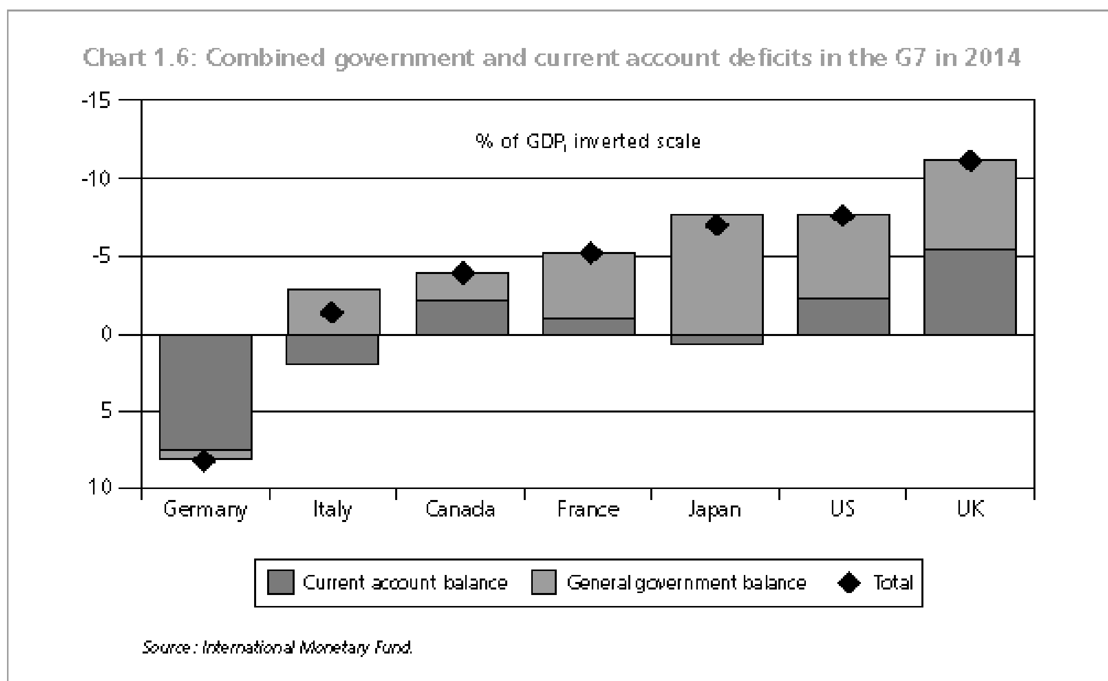
[9] 'Quarterly National Accounts', OECD, June 2015.
[10] 'World Economic Outlook', IMF, April 2015.

lower and this feeds into a weaker outlook for UK trade, with other advanced economies also expecting to see lower exports in the next few years.[11]

1.18 The current account deficit was 5.9% of GDP in 2014. The income balance component of the current account has declined since early 2012, reflecting lower income received from investment abroad. Weaker euro area growth and global prospects have seen UK investments abroad yield lower returns while, in contrast, as the UK economy has continued to recover, the payments made on foreign investments in the UK have increased. The authorities remain vigilant to any risks that may emerge.

1.19 The UK's large current account deficit contributes to the UK running the largest combined government and current account deficits in the G7, as shown in Chart 1.6. A current account deficit means the UK is a net foreign borrower and is acquiring more foreign liabilities than assets. The UK has run a persistent current account deficit for 30 years and a small deficit is sustainable with continued capital inflows. The UK's budget deficit and debt position is in part financed by these capital inflows through purchases of UK government gilts. In comparison, countries that have higher levels of public debt but run small current account surpluses, such as Italy and Japan, are less exposed to financing risks from a shift in overseas invester sentiment. The government's fiscal plan to complete the repair of the public finances should support a gradual narrowing of the current account deficit and reduce this exposure.

Chart 1.6: Combined government and current account deficits in the G7 in 2014



Source: International Monetary Fund.

Housing market and households

1.20 House price growth has moderated over the past year, having grown strongly during early 2014, with annual house price growth slowing to 5.5% in April 2015. Meanwhile, property transactions fell during the second half of 2014 and were 3.1% lower in May 2015 than a year earlier. The OBR forecasts house prices to grow by 5.7% in 2015, followed by 4.1% in 2016, before rising to 5.6% in 2020. Property transactions are forecast to fall by 1.7% in 2015 before growth picks-up, peaking at 5.5% in 2018.

1.21 Household balance sheets have continued to normalise as households have reduced their debt as a proportion of income to 145% in Q1 2015, having peaked at 169% in Q1 2008. While households take on debt over the forecast period they also accumulate assets, meaning

[11] 'World Economic Outlook', IMF, April 2015.

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household net wealth as a proportion of income is forecast by the OBR to increase from 8.3 times income in 2014 to 8.6 times income in 2020.

Global developments

1.22 The strength and sustainability of the global economic recovery is key to UK economic prospects. The global economic recovery remains uneven and the risks from the world economy, not least from within the euro area, demonstrate the need to continue to fix the economy to ensure the UK can deal with risks from abroad.

1.23 In June 2015 the OECD revised down its global growth forecast for 2015 from 3.7% (forecast in November 2014) to 3.1%, with the global recovery gaining momentum but slowly.[12] The OECD revised down its forecast for US growth in 2015 from 3.1%, forecast in its March interim forecast, to 2.0%, while the euro area growth forecast was left unchanged at 1.4% in 2015. China's growth is expected to moderate and to fall below 7% in 2015 to 6.8%.

1.24 The IMF last updated its economic forecast in April 2015 and forecast global growth at 3.5% in 2015.[13] The IMF's forecast included a marked shift in prospects across countries, with upward revisions in the euro area, Japan and India, and downward revisions for some emerging markets and the US. The IMF will publish its revised global growth forecast on 9 July and the forecast will reflect developments over Q1 2015. Euro area growth in Q1 2015 was 0.4%, though the recovery remains vulnerable.[14] The US 2015 growth forecast was revised down in the IMF's June Article IV review to 2.5%, in light of weak Q1 2015 data.[15]

1.25 A number of other downside risks to the global recovery remain, including:

- the clear risk that the ongoing situation in Greece spills over, causing renewed instability
- the risk of renewed weakness in growth and inflation in the euro area
- the risks posed to emerging markets with weak fundamentals from US rate rises and dollar appreciation
- an escalation of geopolitical risks
- the challenge for China in undertaking reform while maintaining financial stability

1.26 The financial crisis in Greece is the biggest single external risk to the UK economy. It is vital that the current uncertainty is resolved, to ensure economic and financial stability across Europe. Britain will be more affected the longer the Greek crisis lasts, and the worse it gets. The government will do whatever is necessary to protect the UK's economic security at this uncertain time.

1.27 To deliver prosperity and security for all, the EU needs to be dynamic and outward focused, putting its resources to the most effective use. It must empower businesses to compete more effectively internationally by accelerating the integration of the single market, especially in services, and the financial, digital and energy sectors. Part of this would be the strengthening of the regulatory framework for business, improving the quality of regulation, and reducing excessive regulatory burdens on business. The EU also needs to be open to international trade and complete free-trade agreements with the US, Japan, and other developed economies, whilst also looking towards important new trading partners in Asia and South America.

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[12] 'OECD Economic Outlook', OECD, June 2015.
[13] 'World Economic Outlook', IMF, April 2015.
[14] 'Quarterly National Accounts', Eurostat, June 2015.
[15] '2015 Article IV Consultation with the United States of America Concluding Statement of the IMF Mission', IMF, June 2015.

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1.28 The government has a clear plan of reform, renegotiation and referendum, to make the EU a source of growth, jobs, innovation and success. The EU must make sure the interests of both those inside and outside the euro area are fairly balanced. The single currency is not for all member states in the EU, but the single market and the EU as a whole must work for all.

1.29 The UK has joined the Asian Infrastructure Investment Bank (AIIB) as a founding member, following the announcement in March that the UK would be the first G7 member to apply to join. The UK's involvement from the outset will help ensure that the AIIB embodies the best standards in accountability, transparency and governance, and help maximise the opportunities for British businesses and British jobs.

Economic outlook

Table 1.1: Summary of the OBR's central economic forecast[1]

	Percentage change on a year earlier, unless otherwise stated						
		Forecast					
	2014	2015	2016	2017	2018	2019	2020
GDP growth	**3.0**	**2.4**	**2.3**	**2.4**	**2.4**	**2.4**	**2.4**
Main components of GDP							
Household consumption[2]	2.5	3.0	2.5	2.4	2.4	2.3	2.0
General government consumption	1.6	1.2	0.5	0.3	0.1	0.3	2.6
Fixed investment	8.6	5.6	5.6	5.5	5.4	5.4	4.1
Business	8.0	6.0	7.2	6.9	6.6	6.5	4.7
General government[3]	3.4	2.4	-0.1	0.9	2.4	2.3	2.0
Private dwellings[3]	13.1	6.3	4.8	4.4	4.0	3.9	3.3
Change in inventories[4]	0.3	-0.2	0.0	0.0	0.0	0.0	0.0
Net trade[4]	-0.6	-0.5	-0.4	-0.2	-0.2	-0.2	-0.2
CPI inflation	**1.5**	**0.1**	**1.1**	**1.6**	**1.8**	**1.9**	**2.0**
Employment (millions)	**30.7**	**31.2**	**31.5**	**31.6**	**31.7**	**31.9**	**32.1**
ILO unemployment (% rate)[5]	**6.2**	**5.4**	**5.1**	**5.2**	**5.3**	**5.4**	**5.4**

[1] All figures in this table are rounded to the nearest decimal place. This is not intended to convey a degree of unwarranted accuracy. Components may not sum to total due to rounding and the statistical discrepancy.
[2] Includes households and non-profit institutions serving households.
[3] Includes transfer costs of non-produced assets.
[4] Contribution to GDP growth, percentage points.
[5] International Labour Organization.
Source: Office for Budget Responsibility, Office for National Statistics.

1.30 The OBR forecasts GDP growth of 2.4% in 2015 and 2.3% in 2016. Growth is revised up in 2017 and 2018 from 2.3% to 2.4% in both years and is unchanged in 2019 at 2.4%. The output gap represents the amount of spare capacity in the economy. The OBR forecasts the remaining spare capacity in the economy to be used up by mid-2018, half a year later than forecast in March 2015.

1.31 The OBR forecasts employment to be 31.2 million in 2015, rising each year to 32.1 million in 2020. Unemployment is forecast to be 5.4% in 2015, falling to 5.1% in 2016 and 5.2% in 2017. Thereafter, unemployment is forecast to be 5.3% in 2018 and 5.4% in 2019 and 2020.

1.32 The OBR has revised up business investment growth in 2015 to 6.0%. Business investment is forecast to grow by 7.2% in 2016 and by 6.5% or more in 2017, 2018 and 2019. The OBR expects private dwelling investment to grow by 6.3% in 2015 and 4.8% in 2016. Exports are forecast to grow by 3.8% in 2015 and 2016. Export growth over the forecast period is offset by import growth.

1.33 CPI inflation is forecast to be below target in 2015 and remain below the 2% inflation target before returning gradually to 2.0% in 2020.

Monetary policy

1.34 Monetary policy has a critical role to play in supporting the economy as the government delivers on its commitment for necessary fiscal consolidation, a policy strategy which has served the UK well since 2010. The government has ensured that monetary policy can continue to play that role fully by updating the UK's monetary policy framework and remit for the Monetary Policy Committee (MPC) at Budget 2013. The MPC has full operational independence to set policy to meet the 2% inflation target as measured by the 12-month increase in the CPI.

1.35 Inflation was 0.0% in March, triggering the second open letter for inflation falling more than 1 percentage point below target, published on 13 May 2015.[16] The low inflation recently experienced in the UK has mostly been driven by global factors, notably the sharp fall in oil prices and the decline in food prices during the second half of 2014. The Governor of the Bank of England's open letter to the Chancellor explained that lower contributions from movements in food, energy and other goods prices accounted for around three-quarters of the shortfall in inflation from target in March.

1.36 Inflation was -0.1% in April and 0.1% in May 2015. The MPC's view is that inflation is likely to remain close to its current rate over the next few months. At the time of the last open letter, the MPC judged it likely that, conditional on interest rates following the path currently implied by market yields, slack in the economy will be absorbed and inflation will return to the 2% target within 2 years.[17]

1.37 The Governor of the Bank of England has been clear that "a temporary period of falling prices, driven by large one-off adjustments in a few specific components of the CPI should not be mistaken for the potentially damaging process of 'deflation'".[18] The Chancellor has welcomed that the MPC remains vigilant to both upside and downside risks to its forecast and stands ready to act if these risks materialise, to ensure inflation remains likely to return to target in a timely fashion.[19]

Credit easing

1.38 Credit conditions for businesses have continued to improve, supported by policy action the government has taken, such as through the Funding for Lending Scheme (FLS) and the British Business Bank. Gross lending to businesses has increased by 18% in the 5 months to May 2015 compared to the same period last year.[20] Gross lending to small and medium-sized enterprises (SMEs) has grown by a similar amount, while net lending to SMEs is also positive so far in 2015, having increased by £0.5 billion since January 2015.[21] Survey evidence also continues to point towards improving conditions. In response to the Federation of Small Businesses Voice of Small Business Survey, more SMEs reported that credit was affordable and available than at any time since the beginning of 2012.[22]

1.39 The FLS will continue to provide support for bank lending to SMEs into 2016. Since its introduction in July 2012, the scheme has contributed to a significant fall in bank funding costs and helped support the improvement in credit conditions. Net lending to SMEs by participants in the scheme was £0.6 billion in Q1 2015.[23] This was higher than the quarterly average of -£0.3 billion over 2014 and consistent with the improvement in lending across the wider market.[24]

[16] Open letter from the Governor of the Bank of England to the Chancellor of the Exchequer, May 2015.
[17] Open letter from the Governor of the Bank of England to the Chancellor of the Exchequer, May 2015.
[18] Open letter from the Governor of the Bank of England to the Chancellor of the Exchequer, May 2015.
[19] Open letter from the Chancellor of the Exchequer to the Governor of the Bank of England, May 2015.
[20] 'Money and Credit: May 2015', Bank of England statistical release, June 2015.
[21] 'Money and Credit: May 2015', Bank of England statistical release, June 2015.
[22] 'FSB Voice of Small Business Index, Quarter 2 2015', Federation of Small Businesses, June 2015.
[23] 'Funding for Lending Scheme – usage and lending data – Q1 2015', Bank of England news release, May 2015.
[24] 'Funding for Lending Scheme – usage and lending data – Q1 2015', Bank of England news release, May 2015.

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The government's fiscal plan

1.40 Since 2010, the government has made significant progress on reducing the deficit and repairing the public finances. Over the course of the last Parliament, the deficit was more than halved as a percentage of GDP from its post-war peak of 10.2% to reach 4.9% in 2014-15.[25] Debt is forecast to have peaked as a share of GDP at the end of 2014-15.[26] However, risks remain to the recovery, including from events in Greece and a slowing global economy. Debt stands at its highest share of GDP since the late 1960s, and the deficit remains among the highest in advanced economies.[27]

1.41 The government is taking further action to complete the repair of the public finances. Running a surplus on the headline measure of borrowing is the most reliable way to bring down debt as a share of GDP in the long term.

1.42 In the last Parliament, the headline measure of public sector net borrowing (PSNB) was reduced by around 1.1% of GDP a year on average.[28] The government has decided to maintain the same average pace of reduction in the headline measure of PSNB in this Parliament to reach an overall surplus in 2019-20.

1.43 Table 1.2 sets out the key fiscal aggregates at the Budget. Public sector net debt (PSND) as a share of GDP is forecast to fall in every year of the Parliament. Debt as a share of GDP in 2019-20 is now forecast to be lower than expected in the March Budget.

Table 1.2: Comparison of key fiscal aggregates to March Budget 2015

	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Public sector net borrowing (£ billion)							
Summer Budget 2015	89.2	69.5	43.1	24.3	6.4	-10.0	-11.6
March Budget 2015[1]	90.2	75.3	39.4	12.8	-5.2	-7.0	–
Change compared to March Budget 2015	-1.0	-5.8	3.7	11.5	11.6	-3.0	–
Public sector net borrowing (% GDP)							
Summer Budget 2015	4.9	3.7	2.2	1.2	0.3	-0.4	-0.5
March Budget 2015[1]	5.0	4.0	2.0	0.6	-0.2	-0.3	–
Change compared to March Budget 2015	-0.1	-0.3	0.2	0.6	0.5	-0.1	–
Public sector net debt (% GDP)							
Summer Budget 2015[2]	80.8	80.3	79.1	77.2	74.7	71.5	68.5
March Budget 2015[1]	80.4	80.2	79.8	77.8	74.8	71.6	–
Change compared to March Budget 2015	0.4	0.0	-0.6	-0.6	-0.1	-0.1	–

[1] Figures for 2014-15 were forecast at March Budget 2015.
[2] Debt at end March 2015 is outturn; GDP centred on end March 2015 reflects the latest GDP forecast from the OBR. Therefore, the figure differs from the June Public Sector Finances release.
Source: Office for Budget Responsibility.

1.44 Tables 1.3 and 1.4 set out the changes between the OBR's March 2015 forecast and Summer Budget 2015 forecast for PSNB and PSND. This shows that, following the in-year savings that the government announced in June and higher tax receipts, borrowing is forecast to be £6 billion lower in 2015-16. Increased asset sales strengthen the fiscal position over the forecast period, lowering the path of debt. This has allowed the government to increase

[25] 'Public Sector Finances', ONS, May 2015.
[26] 'Economic and fiscal outlook', OBR, July 2015.
[27] 'Three Centuries of Data on the UK Economy', Bank of England data; 'IMF Fiscal Monitor', IMF, April 2015.
[28] HMT analysis based on 'Public Sector Finances', ONS, May 2015.

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departmental spending and smooth the path of borrowing over the Parliament, while delivering a larger surplus in 2019-20 than expected in March. Borrowing will be higher in the years 2016-17 to 2018-19 by an average of £9 billion a year, but the surplus of £10 billion in 2019-20 will be £3 billion higher than was forecast in March. Debt as a share of GDP will be lower in 2019-20 than forecast in March.

Table 1.3: Changes to public sector net borrowing since March Budget 2015

			£ billion		
	2015-16	2016-17	2017-18	2018-19	2019-20
March Budget 2015 public sector net borrowing	**75.3**	**39.4**	**12.8**	**-5.2**	**-7.0**
Total forecast change	-3.0	1.3	3.4	5.4	7.4
Total scorecard policy decisions (tax and welfare)	-3.6	-9.1	-11.0	-15.1	-17.1
Total indirect effects of scorecard policy decisions	0.6	-3.4	-4.6	-4.6	-2.2
Changes to OBR implied departmental spending[1]	0.1	14.9	23.7	25.9	8.9
Summer Budget 2015 public sector net borrowing	**69.5**	**43.1**	**24.3**	**6.4**	**-10.0**
Total change to public sector net borrowing since March Budget 2015	*-5.8*	*3.7*	*11.5*	*11.6*	*-3.0*

[1]For consistency with the OBR's Economic and Fiscal Outlook, this is presented on a PSCE in RDEL and PSGI in CDEL basis, and includes changes to DEL not captured by the lines above.

Source: Office for Budget Responsibility, HM Treasury policy costings and HM Treasury calculations.

Table 1.4: Changes to public sector net debt since March Budget 2015

			% GDP		
	2015-16	2016-17	2017-18	2018-19	2019-20
March Budget 2015 public sector net debt	**80.2**	**79.8**	**77.8**	**74.8**	**71.6**
Change in public sector net debt as a result of change in borrowing	-0.4	-0.2	0.4	0.9	0.8
Other changes including asset sales[1]	0.4	-0.5	-1.0	-1.0	-0.9
Summer Budget 2015 public sector net debt	**80.3**	**79.1**	**77.2**	**74.7**	**71.5**
Total change to public sector net debt since March Budget 2015	*0.0*	*-0.6*	*-0.6*	*-0.1*	*-0.1*

[1]Includes impact of change in nominal GDP.

Source: Office for Budget Responsibility and HM Treasury calculations.

1.45 To achieve the surplus in 2019-20 the government will undertake around £37 billion of further consolidation measures. As shown in Table 1.5, this Budget sets out around £17 billion of measures that will reduce the deficit, including £12 billion by 2019-20 from welfare reform and £5 billion by 2019-20 from tackling tax avoidance and tax planning, evasion and non-compliance, and imbalances in the tax system. In the autumn, the government will set out plans to deliver the remaining £20 billion of consolidation measures required to achieve the surplus following a rigorous Spending Review process.

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Table 1.5: Consolidation plans over this Parliament

	£ billion			
	2016-17	2017-18	2018-19	2019-20
Discretionary consolidation[1]	**9**	**20**	**31**	**37**
of which announced at this Budget[2]	**6**	**9**	**13**	**17**
of which welfare reform	5	7	9	12
of which tax avoidance and tax planning, evasion and compliance, and imbalances in the tax system	1	2	4	5
Further consolidation	**3**	**11**	**18**	**20**

[1] Discretionary consolidation is calculated as the sum of: receipts from avoidance and tax planning, evasion and compliance and imbalances in the tax system and welfare policy decisions announced at Summer Budget 2015 and set out in Table 2.1; and the additional reduction in spending (or equivalent increase in taxes) needed to meet the government's overall fiscal path, compared to a counterfactual in which RDEL excluding depreciation grows in line with the whole economy inflation from its 2015-16 level (excluding the OBR's Allowance for Shortfall) and all other spending (and receipts) follows the OBR's latest fiscal forecast.

[2] Total welfare policy decisions and total receipts from avoidance and tax planning, evasion and compliance, and imbalances in the tax system as set out in Table 2.1.

Source: Office for Budget Responsibility, HM Treasury policy costings and HM Treasury calculations.

1.46 The Spending Review will identify further reductions, while confirming increased spending on the NHS and ensuring the UK spends 2% of GDP a year on defence. The government will also look to do more to tackle avoidance and tax planning, evasion and compliance, and imbalances in the tax system, and will continue to consider sensible welfare reform.

The long-term debt challenge

1.47 High debt means a high burden of interest costs on future generations. Even with interest rates at historically low levels, central government gross debt interest spending equates to the budgets of the Ministry of Defence and Home Office combined in 2015-16, as set out in Table 2.3.[29] Reducing debt from its current high levels will also help prepare the UK to deal with future pressures from an ageing population.

1.48 High debt increases the UK's vulnerability to future shocks. Evidence suggests that at higher debt levels, the scope for fiscal policy to stabilise the economy is reduced.[30] A higher starting level of debt also increases the risk that a further shock to the public finances could increase debt to a level that the markets would view as potentially unsustainable, increasing interest rates.

1.49 The evidence suggests that negative effects of debt are likely to start to dominate with gross debt in the region of 70-90% of GDP. Without further debt reduction, a future economic shock on the scale of the Great Recession of 2008 would take debt to well over 100% of GDP.[31] This risk can be exacerbated by country-specific factors, such as potential vulnerabilities from the UK's large current account deficit, large financial centre, and any negative feedback of high debt on growth.[32]

1.50 A strategy for debt reduction must take into account the possibility of future economic shocks. The UK economy has been subject to relatively frequent shocks in the past and though the nature and timing are unpredictable, prudent fiscal policy should allow for them. Any analysis is necessarily illustrative, but Chart 1.7 below shows the impact on debt by 2035-36 of

[29] Interest rate data from DMO daily gilt prices (1996-present), and Bank of England yield curve archive (1976-1996); central government gross debt interest in 2015-16 as in 'Economic and fiscal outlook', OBR, July 2015.
[30] See, e.g., 'New Evidence on the Private Saving Offset and Ricardian Equivalence', Rohn, O., OECD Economics Department Working Papers, No. 762, 2010; 'Fiscal Policy Reaction to the Cycle in the OECD: Pro- or Counter-cyclical?', Egert, B., OECD Economics Department Working Papers, No. 763, 2010; 'Fiscal stimulus in times of high debt: reconsidering multipliers and twin deficits', Nickel, C. and A. Tudyka, ECB Working Paper No 1513, February 2013.
[31] 'Prudent debt targets and fiscal frameworks', Fall, F. et al., OECD Economic Policy Paper No. 15, July 2015.
[32] 'Fiscal Monitor', IMF, April 2013; 'Prudent debt targets and fiscal frameworks', Fall, F. et al., OECD Economic Policy Paper No. 15, July 2015, and references therein.

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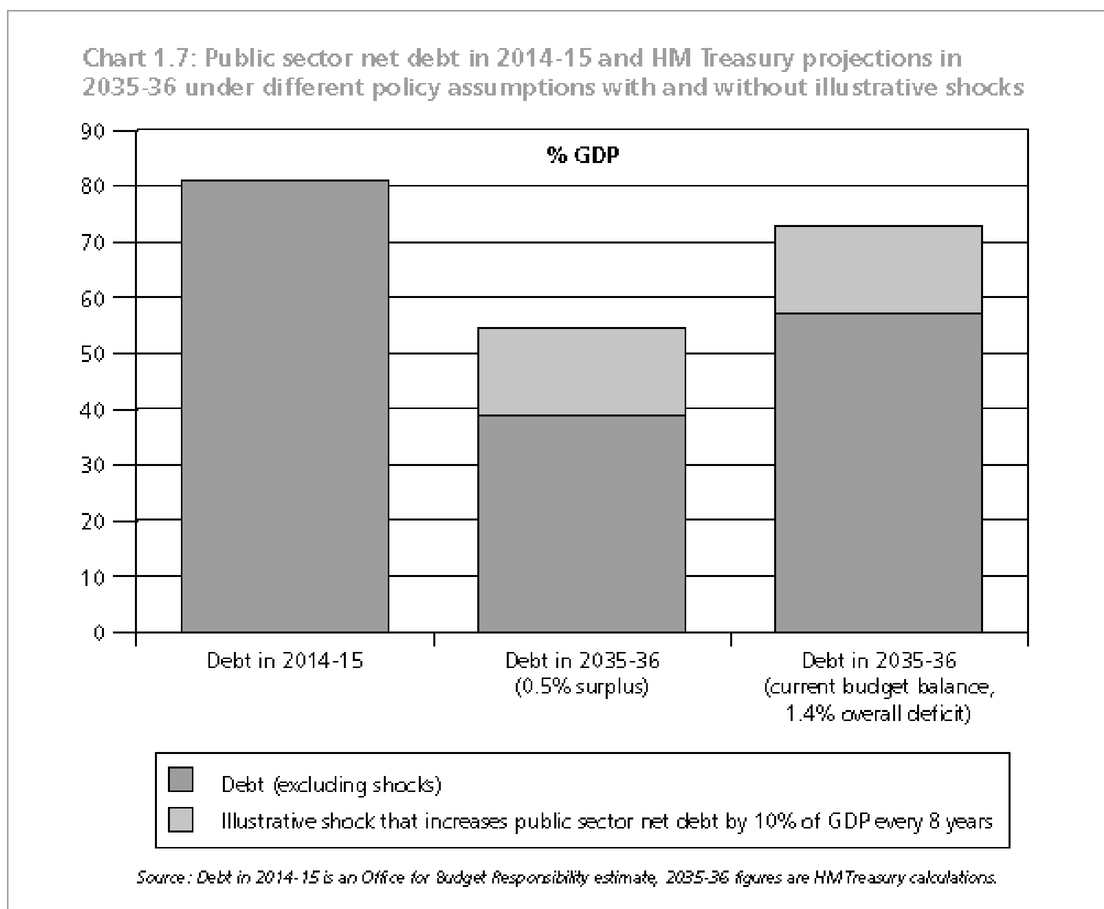
a simple scenario in which the economy is hit once every 8 years by a shock that increases PSND by 10% of GDP.[33] In this illustrative scenario, running a permanent 1.4% deficit (equivalent to a balanced current budget) after 2020-21 means debt only falls by 8% of GDP between its peak in 2014-15 and 2035-36. In comparison, continuing to run an overall surplus of 0.5% beyond the forecast period reduces debt by 28% of GDP.

Chart 1.7: Public sector net debt in 2014-15 and HM Treasury projections in 2035-36 under different policy assumptions with and without illustrative shocks



Source: Debt in 2014-15 is an Office for Budget Responsibility estimate, 2035-36 figures are HM Treasury calculations.

1.51 Any strategy for long-term debt reduction must also take into account the UK's low inflation environment. Independent monetary policy now delivers low and stable medium-term inflation, to the benefit of the whole economy. This contrasts with the experience after World War II, when very high inflation, together with financial repression, played a major role in reducing debt.[34] Substantial debt reduction in future will depend on responsible management of the public finances and sustainable economic growth.

1.52 The only reliable way to bring debt down to safer levels is to run a surplus in normal times.[35] Running a surplus will mean that debt falls rapidly when the economy is growing normally – ensuring that long-term debt reduction will not be knocked off-course by periodic shocks.

[33] 8 – 9 years is average gap between technical recessions in the UK since 1955 (HM Treasury calculation based on ONS data), though past recessions have not been evenly spaced; a 10% increase in debt is less than the peak increase following the 1990s recession.
[34] 'The liquidation of government debt', Reinhart, C. and M. Sbrancia, 2011; 'Fiscal sustainability report', OBR, 2013.
[35] This approach is formalised in the updated Charter for Budget Responsibility: once a surplus is achieved, the government should maintain a surplus unless and until real GDP growth falls below 1% on a rolling 4 quarter-on-4 quarter measure.

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Charter for Budget Responsibility

1.53 The government has published a draft Charter for Budget Responsibility (the "Charter") to entrench this commitment to reach an overall surplus and maintain it in normal times. The draft Charter sets out:

- a target for a surplus on public sector net borrowing in 2019-20, and a supplementary target for public sector net debt to fall as a share of GDP in each year from 2015-16 to 2019-20
- a target, once a surplus is achieved in 2019-20, to run a surplus each subsequent year as long as the economy remains in normal times

1.54 These targets will apply as long as the economy is not hit by a significant negative shock that reduces real GDP growth to less than 1% (on a rolling 4 quarter-on-4 quarter basis). If the OBR judge that the economy has been hit by a shock, the surplus rule will be suspended. This will allow the automatic stabilisers to support the economy when they are needed. The framework therefore supports fiscal discipline in normal times, while ensuring that future governments will have the flexibility to respond appropriately to shocks.

1.55 Following a shock, the government of the day will be required to set a plan to return to surplus. This plan must include appropriate fiscal targets. The framework does not prescribe what the targets should be, allowing the government of the day to respond to the circumstances. However, the targets will be voted on by the House of Commons and assessed by the OBR. A surplus in normal times is necessary to provide the government of the day with the fiscal space to allow appropriate action to be taken in the face of these shocks. The end goal must be to return the public finances to surplus, ensuring that long-term debt reduction continues.

1.56 The Charter will be laid before Parliament and voted on by the House of Commons in the autumn of 2015.

The OBR's fiscal forecast

1.57 As a result of the government's plan, the OBR is forecasting that the public finances will return to surplus in 2019-20. The surplus in 2020-21 would be the largest structural surplus in 40 years.

1.58 Table 1.4 sets out the OBR forecast for key fiscal aggregates over this Parliament, based on the strategy defined in this Budget.

1.59 From its post-war peak of 10.2% of GDP in 2009-10[36], PSNB is forecast to fall to:

- 3.7% of GDP in 2015-16
- a surplus of 0.4% of GDP in 2019-20 and 0.5% of GDP in 2020-21

1.60 PSND is forecast to peak at 80.8% of GDP in 2014-15, before falling each year and reaching 68.5% of GDP in 2020-21.

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[36] 'Public Sector Finances', ONS, May 2015.

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Table 1.6: Overview of the OBR's central fiscal forecast

	% GDP, unless otherwise stated						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Fiscal mandate							
Cyclically-adjusted current budget deficit	2.4	1.7	0.5	-0.3	-1.1	-1.8	-1.9
Deficit							
Public sector net borrowing	4.9	3.7	2.2	1.2	0.3	-0.4	-0.5
Public sector net borrowing (£ billion)	89.2	69.5	43.1	24.3	6.4	-10.0	-11.6
Cyclically-adjusted net borrowing	4.1	3.2	2.0	1.1	0.3	-0.5	-0.5
Current budget deficit	3.2	2.2	0.8	-0.2	-1.1	-1.8	-1.9
Primary balance	-3.4	-2.1	-0.4	0.8	1.7	2.4	2.3
Cyclically-adjusted primary balance	-2.6	-1.7	-0.2	0.9	1.7	2.4	2.3
Treaty deficit[1]	5.1	4.0	2.3	1.4	0.5	-0.3	-0.4
Cyclically-adjusted Treaty deficit	4.3	3.6	2.1	1.2	0.4	-0.3	-0.4
Debt							
Public sector net debt[2, 3]	80.8	80.3	79.1	77.2	74.7	71.5	68.5
Treaty debt[4]	88.5	87.6	86.8	85.2	82.8	79.8	76.4
Memo: Output gap	*-0.8*	*-0.6*	*-0.3*	*-0.1*	*0.0*	*0.0*	*0.0*
Memo: Total policy decisions[5]		*0.2*	*0.5*	*0.5*	*0.7*	*0.8*	*0.8*

[1] General government net borrowing on a Maastricht basis.
[2] Debt at end March; GDP centred on end March.
[3] Debt at end March 2015 is outturn; GDP centred on end March 2015 reflects the latest forecast from the OBR. Therefore, the figure differs from the June Public Sector Finances release.
[4] General government gross debt on a Maastricht basis.
[5] Equivalent to the 'Total policy decisions' line in Table 2.1.
Source: Office for National Statistics, Office for Budget Responsibility and HM Treasury calculations.

1.61 The plan to reach a surplus involves a sustained improvement in the fiscal position over the years to 2019-20. The government's preferred measure of the deficit (PSNB) will fall by around 1.1% of GDP a year on average. This is the same rate as over the last Parliament.

1.62 The OBR forecasts that this fiscal path will lead to a significant reduction in PSND as a share of GDP over the course of this Parliament. As shown in Chart 1.9 debt is forecast to fall in every year of the Parliament, reaching 71.5% of GDP in 2019-20 (a lower level than forecast in March) and 68.5% of GDP in 2020-21.

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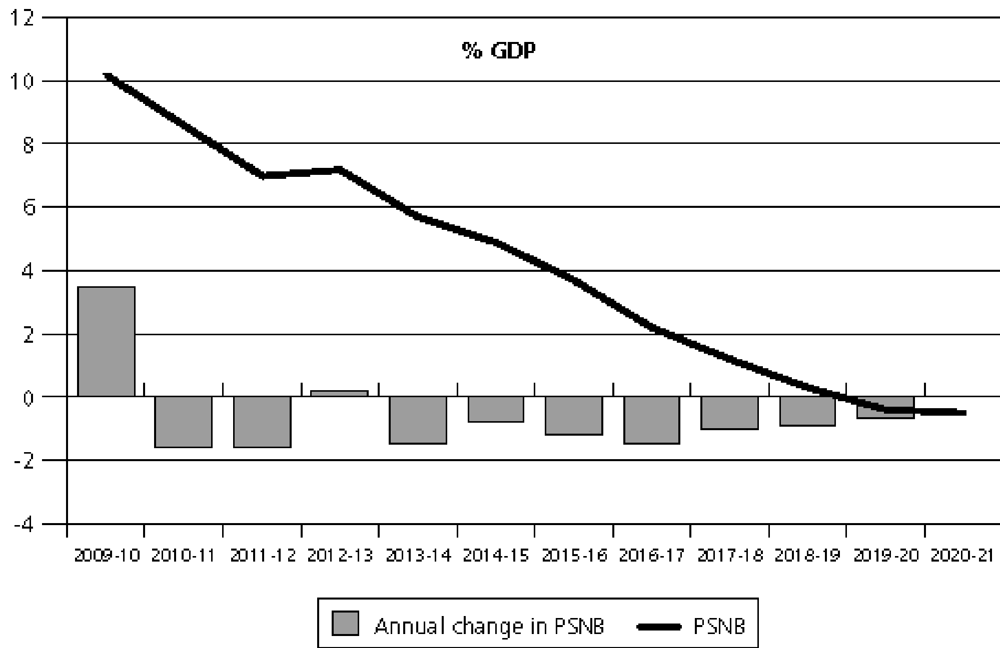
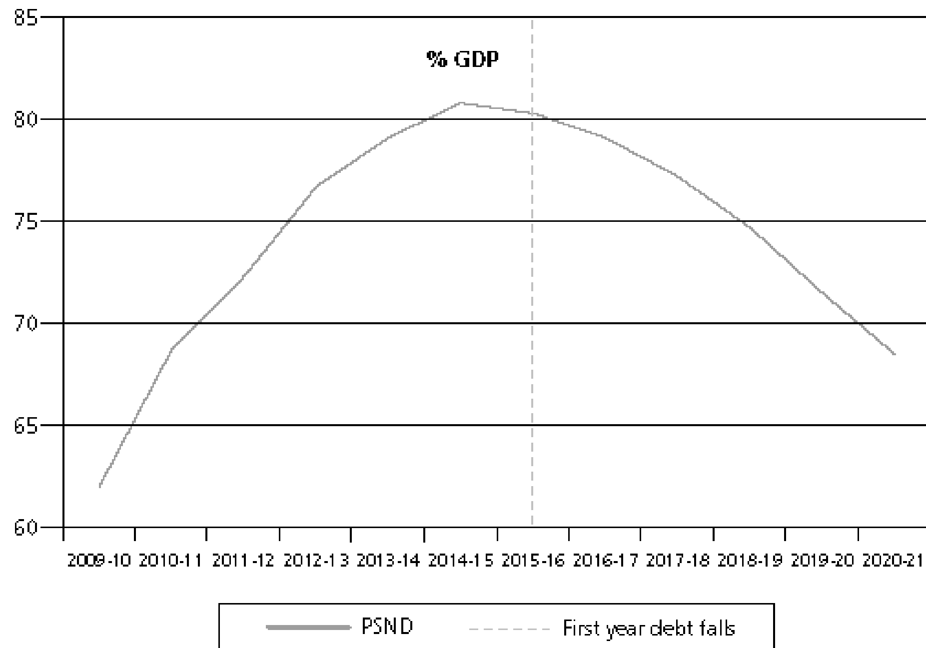
Chart 1.8: Public sector net borrowing, level and annual change from 2009-10 to 2020-21



Note: PSNB in 2012-13 includes a one-off £9.5bn increase due to transfers from the Royal Mail Pension plan. This accounts for the PSNB increase in this year shown; adjusting for this PSNB falls in all years.

Source: Office for National Statistics and Office for Budget Responsibility.

Chart 1.9: Public sector net debt



Note: Public sector net debt in 2014-15 is an Office for Budget Responsibility estimate, for the period from 2015-16 to 2020-21 it is an Office for Budget Responsibility forecast.

Source: Office for National Statistics and Office for Budget Responsibility.

Fixing the public finances and returning a surplus

1.63 The government has set out its fiscal plan, to consolidate at the same pace on average as the last Parliament to reach a surplus in 2019-20. This is a smoother path of consolidation than was planned in March, but will still require action in order to achieve the surplus.

1.64 The sections below set out the measures the government will undertake over this Parliament to repair the public finances. These measures also deliver by 2019-20 the planned contributions of £5 billion from avoidance and tax planning, evasion and compliance, and imbalances in the tax system, and £12 billion from welfare. Plans to deliver the remaining consolidation will be set out in the autumn following a rigorous Spending Review process.

Tax

1.65 The government believes in lower taxes, and is committed to eliminating the deficit in a way that is fair to taxpayers. The cornerstone of this commitment is to introduce into legislation a tax lock to rule out increases in the main rates of income tax, VAT or National Insurance over the course of this Parliament.

1.66 This Budget addresses imbalances in the tax system in order to pay for tax reforms to support individuals and businesses. By 2017-18, 8 out of 10 working households will be better off as a result of the income tax Personal Allowance, living wage and welfare (including tax credits) changes in this Budget. On average, these households will be £130 per year better off.

1.67 The majority of individuals and businesses pay their fair share of tax. However, there are some who fail to pay what they owe due to error or a failure to comply with their obligations as a taxpayer, and a small minority who try to evade or aggressively avoid paying the tax they should. As part of its consolidation plans, the government will raise at least an additional £5 billion a year by 2019-20 by tackling avoidance and tax planning, evasion and compliance, and by addressing imbalances in the tax system.

1.68 Further details of measures to ensure that individuals and businesses pay what they owe, and to address imbalances in the tax system, are set out later in this chapter.

Welfare

1.69 The government's welfare cap is a firm limit on welfare spending, applying to spending in Annually Managed Expenditure with the exception of the state pension and the automatic stabilisers.

1.70 Consistent with the Charter for Budget Responsibility, the government is setting the welfare cap for this Parliament in this Budget. The welfare cap is set at the level of the OBR's forecast for spending in scope of the cap. The cap therefore reflects the welfare savings announced at this Budget, and improvements in the forecast since the cap was last set at Budget 2014. By setting the cap at the level of the new forecast, the government is committing to deliver the welfare savings set out at this Budget. The forecast margin will be set at 2% of the new cap.

Table 1.7: Welfare cap

	£ billion				
	2016-17	**2017-18**	**2018-19**	**2019-20**	**2020-21**
Welfare cap	115.2	114.6	114.0	113.5	114.9
Forecast margin (2%)	2.3	2.3	2.3	2.3	2.3

Source: HM Treasury, based on Office for Budget Responsibility forecast.

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1.71 In the last Parliament, the government legislated for over £21 billion of welfare savings.[37] As the recovery takes hold, it is right that welfare savings continue to play a role in the deficit reduction plan.

1.72 The government's plans for reducing the working-age welfare bill are set out below. The government is reforming the welfare system to make it more affordable and fairer to taxpayers, while continuing to support the most vulnerable. As a result of measures announced in this Budget, welfare spending will be £12 billion lower in 2019-20 than would otherwise have been the case. Working-age welfare spending is now forecast to grow at -2.3% annually in real terms over the Parliament, compared to -0.6% over the last Parliament and 4.0% over the 2005-10 Parliament.[38]

Public spending

1.73 The government has already identified a further £3 billion of departmental savings in 2015-16.[39] The departmental savings have been achieved through efficiency savings, tighter control of budgets to drive underspends in-year, and through asset sales.

1.74 The government will set out how the remaining consolidation will be delivered in the autumn following a rigorous Spending Review process.

1.75 The Spending Review will look at all elements of public spending in order to create a more efficient public sector, whilst continuing to prioritise growth-promoting expenditure and spending on public services for those who need them the most.

Funding for healthcare

1.76 The NHS 'Five Year Forward View' outlines a plan for a more sustainable, integrated health service that cares for people closer to home.[40]

1.77 The Budget protects spending on the NHS in England and backs its 5-year plan. The government will continue to spend more on the NHS in real terms every year, as it has in every year since 2010. It will fully fund the NHS plan which called for £8 billion more by 2020-21. This additional funding comes on top of the £2 billion announced at Autumn Statement 2014.

1.78 **The Budget therefore commits to increase NHS funding in England by £10 billion in real terms by 2020-21, above 2014-15 levels.** This additional investment will support the NHS in England to go further than its plan and to deliver a step change in safety, quality and access.

1.79 The Five Year Forward View set out how, with the additional funding confirmed in this Budget, the NHS will deliver £22 billion in efficiency savings by 2020-21. This will come through improvements to quality of care and staff productivity, and better procurement.

1.80 The government will ensure the NHS becomes a 7-day service by 2020-21. Hospitals will be appropriately staffed at weekends to ensure people can obtain the care they need every day of the week. Everyone will be able to access GP services from 8am – 8pm seven days a week. These improvements will allow people to better balance work, health and family and will be a key to a more productive economy.

Funding for defence and security

1.81 The first duty of government is to ensure the safety and security of the country and its people. The government remains committed to ensuring real growth of the Ministry of Defence equipment plan of 1% per year and maintaining the size of the Army at 82,000. The government will go further, and **this Budget commits to raise the entire Ministry of Defence budget by 0.5% a year in real terms.** This Budget also **protects overall counter**

[37] HMT analysis, based on OBR's policy measures database.
[38] HMT analysis using DWP benefit expenditure and caseload tables, OBR forecast, GDP deflators from ONS (outturn) and OBR (forecast).
[39] 'Chancellor announces £4 billion of measures to bring down debt', HM Treasury, 4 June 2015, available on gov.uk.
[40] 'Five Year Forward View', NHS, October 2014.

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terrorism spending across government, a total of more than £2.0 billion spent by a range of departments, agencies, and the police.

1.82 The threats the UK faces are diverse and require coordinated responses from the armed forces, security and counter terrorism agencies. In addition to the annual increase in the defence budget, **this Budget announces up to an additional £1.5 billion a year by the end of the Parliament to fund increased spending on the military and intelligence agencies by an average of 1% a year in real terms.**

1.83 The final allocation of this additional funding will be determined by the Strategic Defence and Security Review and Spending Review, and is conditional on the armed services and agencies producing further efficiencies within their existing budgets to ensure continued investment in the most important capabilities.

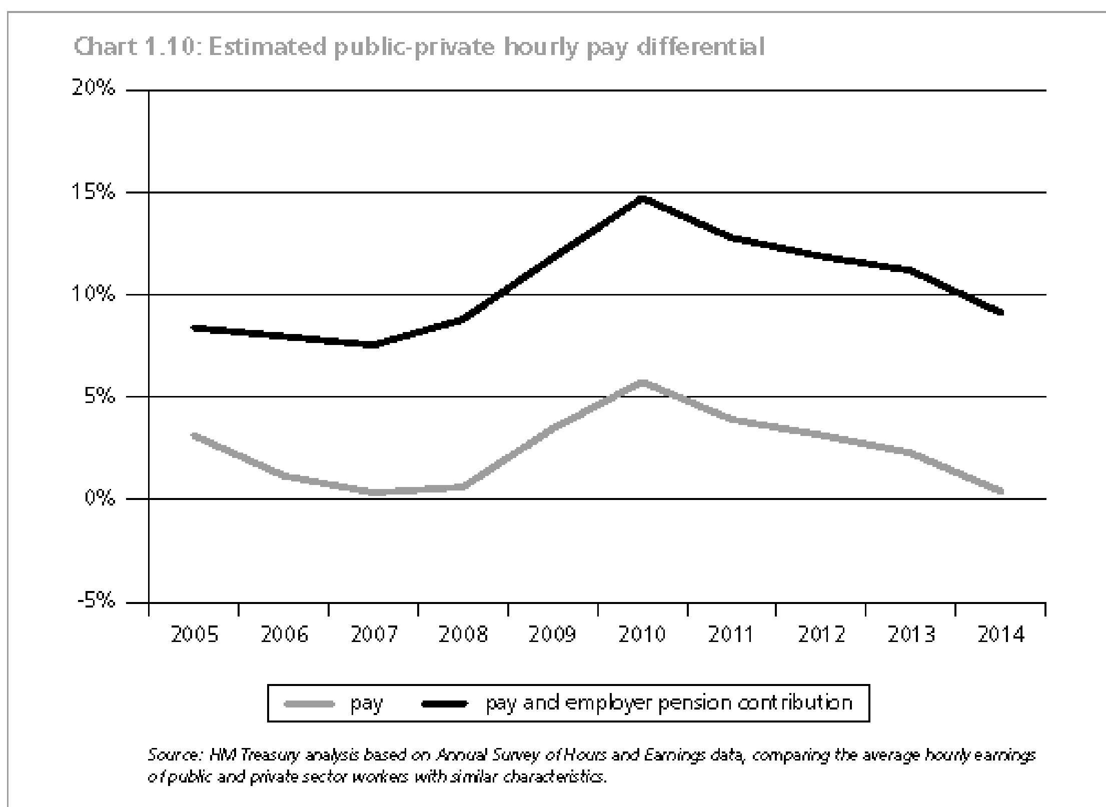
1.84 Allowing for all of the public spending that supports the Ministry of Defence and the contribution made by the secret intelligence agencies, **this Budget commits the government to meet the properly measured NATO pledge to spend 2% of national income on defence every year of this decade.**

Public sector pay and pensions

1.85 In the last Parliament, the government exercised firm restraint over public sector pay to deliver reductions to departmental spending, saving approximately £8 billion.[41] As set out by the Chancellor at Autumn Statement 2014, the government will need to continue to take tough decisions on public sector pay in order to deliver reductions to departmental spending and protect the quality of public services.

1.86 Overall, levels of pay in the public sector are now, on average, comparable to those in the private sector. However, public sector workers continue to benefit from a significant premium once employer pension contributions are taken into account, as shown in Chart 1.10.

Chart 1.10: Estimated public-private hourly pay differential



Source: HM Treasury analysis based on Annual Survey of Hours and Earnings data, comparing the average hourly earnings of public and private sector workers with similar characteristics.

[41] HM Treasury analysis.

1.87 In light of this and continued low inflation, **the government will therefore fund public sector workforces for a pay award of 1% for 4 years from 2016-17 onwards.** This will save approximately £5 billion by 2019-20.[42] The government expects pay awards to be applied in a targeted manner within workforces to support the delivery of public services.

1.88 As part of the forthcoming Spending Review, the government will continue to examine pay reforms and modernise the terms and conditions of public sector workers. This will include a renewed focus on reforming progression pay, and considering legislation where necessary to achieve the government's objectives.

1.89 The government will work with Local Government Pension Scheme administering authorities to ensure that they pool investments to significantly reduce costs, while maintaining overall investment performance.

Efficiency and reform

1.90 The government will continue to pursue more efficient ways of working and further reform to public services. **The government will provide funding for the Cabinet Office to explore a number of cross-cutting savings proposals. The Treasury, working with Cabinet Office, will develop specific proposals to inform the Spending Review.**

1.91 At Spending Round 2013, the government announced a control total would limit payments under PFI and PF2 contracts in nominal terms in each future Parliament. As reported by the OBR, the Treasury is on track to meet this target, with forecast cumulative spending from 2015-16 to 2019-20 for payments on all PFI contracts funded by central government standing at £51.9 billion.[43]

BBC

1.92 **The BBC has agreed to take on responsibility for funding the over-75s licence fee concession, which will help contribute to reductions in public spending.** This will be phased in from 2018-19, with the full liability being met by the BBC from 2020-21. As part of these new arrangements, the government will ensure that the BBC can modernise the licence fee to cover public service broadcast catch-up television and anticipates that the licence fee will rise in line with CPI over the next Charter period, subject to Charter Review conclusions on the purposes and scope of the BBC, and the BBC demonstrating that it is undertaking efficiency savings at least equivalent to those in other parts of the public sector.

Financial sector and other state-owned asset sales

1.93 The government is committed to returning the financial sector assets that were acquired in 2008 and 2009 to the private sector. The government will seek to dispose of other commercial and financial assets, which there is no policy reason for the government to hold, in order to maximise value for taxpayers and reduce the level of public debt. Significant progress towards this goal has already been made.

1.94 As set out in the OBR's July 2015 'Economic and fiscal outlook', to date the government has made the following recoveries from financial sector interventions:

- over £40 billion through selling shares in Lloyds Banking Group, and repayments from the Royal Bank of Scotland (RBS), UK Asset Resolution (UKAR) and the estates of failed banks
- almost £20 billion in other fees received from Lloyds, RBS, UKAR and other financial institutions relating to government support and participation in government intervention schemes – all of which are no longer required

[42] HM Treasury analysis.
[43] 'Fiscal sustainability report', OBR, June 2015.

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1.95 The government has also completed disposals of Eurostar (£757 million) and Royal Mail shares (£750 million) in 2015-16.[44]

1.96 In light of independent advice, the government will begin to sell off its stake in RBS in the next few months.[45] **Over the course of this Parliament, the government will dispose of at least three-quarters of its stake in RBS, starting with a sale in the coming months.** The government expects to raise at least £2 billion in 2015-16. All options for near-term disposals will be considered.

1.97 **Through the ongoing Lloyds Banking Group trading plan, which was extended on 1 June 2015 for a further six months, the government has sold over £5 billion of shares, reducing the taxpayer's stake to under 16%.**[46] The government will launch a further share sale which will be open to retail investors in the next 12 months. Further details will be set out in due course.

1.98 UKAR are also on track to complete the sale of assets announced at Budget 2015 from the forced nationalisation of Northern Rock and Bradford & Bingley plc, and in parallel are exploring options for the sale or outsourcing of its mortgage servicing activities.

1.99 **The government intends to complete the sale of its remaining 14% shareholding in Royal Mail by the end of 2015-16**, subject to achieving value for money. This is expected to raise around £700 million.

1.100 **The government is exploring options to move the Green Investment Bank into private ownership.** This will ensure the future sustainability of the bank as well as increasing its impact by freeing it from the constraints of state aid and competition for public funding.

1.101 By the end of 2015-16 and subject to value for money, the government intends to sell its shareholding in the Kings Cross property development (valued at £345 million in the Department for Transport's accounts) and expects to sell the first tranche of the pre-Browne income contingent repayment student loan book.[47] There is a central estimate of £12 billion for total proceeds from tranches to be sold up to 2020. The government is also continuing to work towards a sale of its 33% shareholding in Urenco.

1.102 In 2013, the government set a target of selling £20 billion of corporate and financial assets between 2014 and 2020. With sales to date this target is over two thirds of the way to being met.[48] Sales planned for the remainder of the year mean the government expects to significantly exceed the target during 2015-16.

1.103 Taken together, the government's central estimate, certified by the OBR, is that these sales of financial and commercial assets will raise approximately £31 billion in 2015-16, achieving value for money for the taxpayer and further reducing public debt.

1.104 Overall, planned sales for 2015-16 amount to the largest privatisation proceeds in a single year ever. This is over £10 billion higher in real terms than the previous record in 1987-88.[49]

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[44] 'UK Government reaches agreement on the sale of its entire interest in Eurostar for £757.1m', HM Treasury, 4 March 2015; 'Government sells 15% of shares in Royal Mail at 500p per share', Department for Business, Innovation & Skills, 11 June 2015; both available on gov.uk
[45] 'Exchange of letters on the government's shareholdings in Royal Bank of Scotland', HM Treasury, 10 Jun 2015; 'Rothschild report on the government's shareholdings in the Royal Bank of Scotland (RBS)', HM Treasury, 10 Jun 2015; both available on gov.uk.
[46] 'Lloyds share sales have now raised over £12.5bn for the taxpayer', HM Treasury, 2 July 2015, available on gov.uk.
[47] Kings Cross property development valuation in 'Annual Report and Accounts 2013 to 2014', Department for Transport, June 2014.
[48] Published sales of corporate and financial assets since January 2014 (Lloyds Banking Group (multiple sales), UK Asset Resolution Ltd mortgage portfolio, ConstructionLine, Greencoat UK Wind, Food and Environment Research Agency, Defence Support Group, Eurostar, Royal Mail) total around £13.7 billion, of which £4.8 billion since Budget 2015.
[49] HMT analysis. Data prior to 2010 from 'Privatisation', House of Commons Library Research Paper 14/61, November 2014. Data for 2010 to 2015 from published announcements.

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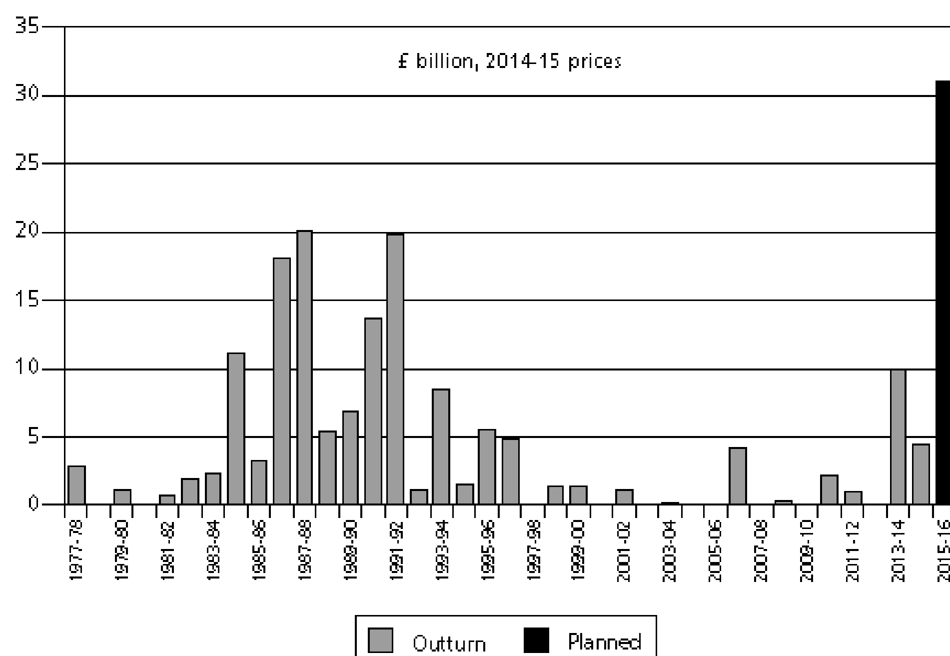
Chart 1.11: Real value of corporate and financial asset sales since 1977-78 including plans for 2015-16



Source: HM Treasury analysis.

Performance against the fiscal mandate

1.105 The government's fiscal strategy, as set out in the current Charter for Budget Responsibility published during the last Parliament, is underpinned by the forward-looking mandate to balance the cyclically-adjusted current budget by the end of the third year of the rolling 5-year forecast period. The government remains on course to meet the current fiscal mandate, with the OBR forecast indicating that cyclically-adjusted current budget balance will be achieved a year early in 2017-18.

1.106 The government's fiscal mandate is supplemented by a target for PSND as a percentage of GDP to be falling in 2016-17. The OBR forecasts PSND falls 1.1% of GDP between 2015-16 and 2016-17. Additionally, PSND as a share of GDP will start to fall one year earlier in 2015-16. This will be the first time that PSND has fallen as a share of GDP since 2001-02.[50]

1.107 The OBR forecasts that the government is on course to meet the new fiscal mandate proposed in the Budget to reach an overall surplus in 2019-20, and the new supplementary target for debt as a share of GDP to be falling in every year to 2019-20.

Performance against EU deficit targets

1.108 The government remains committed to bringing the UK's Treaty deficit in line with the 3% target set out in the Stability and Growth Pact (SGP). The current forecast indicates that this target will be met in 2016-17.

[50] 'Public Sector Finances', ONS, May 2015.

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Debt and reserves management

1.109 The government's revised financing plans for 2015-16 are summarised in Annex A. The debt management framework was set out in the 'Debt and Reserves Management Report 2015-16', published alongside the March Budget 2015, and this framework remains in place.

1.110 National Savings and Investments (NS&I) have a net financing target which remains at £10.0 billion in 2015-16, within a range of £8.0 to £12.0 billion.

1.111 The net financing requirement for the Debt Management Office (DMO) is projected to fall by £14.0 billion to be £123.9 billion. It is planned that this will be met through gilt issuance of £127.4 billion and a reduction of £3.5 billion in the stock of Treasury bills.

1.112 The financing arithmetic provides for £5.3 billion of sterling financing for the Official Reserves in 2015-16, as set out in the Revision to the DMO's Financing Remit 2015-16 on 23 April 2015.[51] The government is planning on the basis of sterling financing for the Official Reserves of £6 billion per year on average, over the 4 years from 2016-17 up to and including 2019-20; thereafter the government has adopted a neutral assumption.

[51] 'CGNCR Outturn 2014-15: Revision to the DMO's Financing Remit 2015-16', Debt Management Office, April 2015.

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1.113 Underpinning the government's approach is a commitment to reward work and back aspiration, while continuing to support the most vulnerable in society. This Budget builds an economy where people get a fair day's pay for a fair day's work by earning more and keeping more of what they earn. It ensures that welfare expenditure is controlled and that the welfare system is fair to taxpayers who pay for it.

1.114 The Budget will support working people by introducing a new National Living Wage (NLW) to lift the wages of the lowest paid, while setting out the path to a tax-free National Minimum Wage (NMW). The Budget cuts taxes so working families can keep more of what they earn by raising the personal allowance and delivering a real terms increase in the higher rate threshold of income tax for the first time since 2010. And it will take the family home out of inheritance tax for all but the wealthiest.

1.115 The Budget reforms welfare so that it is fair both to those who need it, and those who pay for it. It makes the whole system more sustainable and rewards work.

1.116 The Budget ensures the deficit is cut in a fair way by taking significant action to tackle tax avoidance and aggressive tax planning, tax evasion and compliance, and address imbalances in the tax system.

1.117 The UK's strong labour market has resulted in a substantial fall in income inequality, with inequality in original incomes (before taxes and benefits) now at its lowest point for 25 years. In addition, as a result of the decisions of this government and the previous government, the poorest fifth of households receive the same proportion of public spending (24%) as they did before consolidation. However, tax decisions have shifted the burden onto the rich: before consolidation, the richest fifth paid 49% of tax; this has increased to 52%.

A higher wage, lower tax, lower welfare society

1.118 The government wants to move from a low wage, high tax, high welfare society to a higher wage, lower tax, lower welfare society. Over the last Parliament, those on the lowest wages saw their pay steadily rise, with the NMW now standing at £6.50. Tax reforms took millions of people out of income tax and reduced income tax for millions more. Flagship welfare reforms have started to bring expenditure under control and ensure that the system rewards work. And the government is delivering on its pledge to create full employment. In the last Parliament, the Jobseeker's Allowance claimant count reached its lowest ever level, 2 million new jobs were created and the UK recently overtook Canada to have the third highest employment rate in the G7.

1.119 With a record high of 31.1 million people now in employment, record levels of vacancies, and an economy that was the fastest growing in the G7 in 2014 and is forecast by the OECD to be the fastest growing again in 2015,[52] the government will take further steps towards the vision of an economy and society where people are better paid and keep more of what they earn, instead of relying on an ever increasing benefit system.

A higher wage society: the National Living Wage

1.120 The UK has a higher incidence of low pay than other advanced economies: 1 in 5 UK workers is low-paid, compared to an average of only 1 in 6 among OECD countries.[53] With a strengthening economy, the government believes that now is the right time to take action to

[52] 'OECD Economic Outlook' OECD, June 2015.
[53] 'OECD Employment Outlook' OECD, September 2014.

tackle low pay and ensure that lower wage workers can take a greater share of the gains from growth.

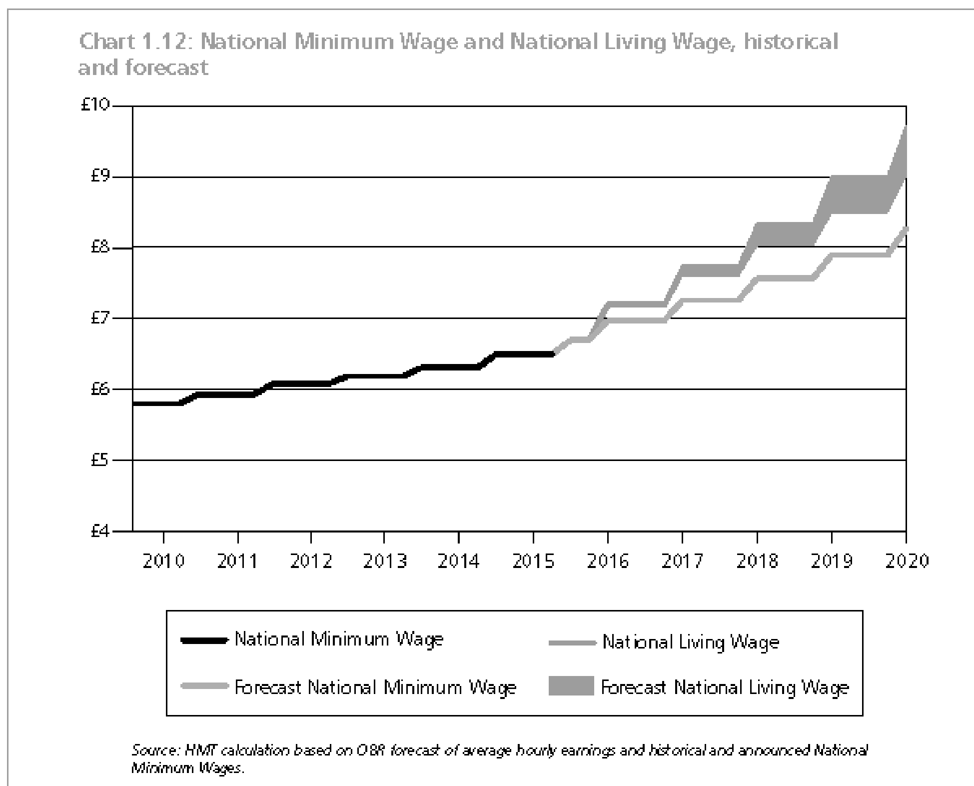
1.121 **The government will therefore introduce a new National Living Wage (NLW) for workers aged 25 and above, by introducing a new premium on top of the NMW. From April 2016, the new NLW will be set at £7.20 – a rise of 70p relative to the current NMW rate, and 50p above the NMW increase coming into effect in October 2015.**

1.122 **The government will ask the Low Pay Commission (LPC) to set out how the new NLW will reach 60% of median earnings by 2020. Based on the OBR's earnings forecasts, this means that the NLW will reach the government's target of over £9 by 2020.** 60% of median earnings is in line with the approach suggested by Professor Sir George Bain, the first chair of the LPC, in a 2014 report on the future on the NMW.

1.123 This will mean a direct boost in earnings for 2.7 million low wage workers, and the OBR have indicated that knock-on effects further up the wage distribution could mean a further 3.25 million people also see an increase in wages as a result of the NLW. By the end of the Parliament, an individual aged over 25 working 35 hours a week and previously earning the NMW will see their gross wages increase by around a third compared to 2015-16, or £5,200 in cash terms. This is equivalent to an extra £2,000 per year from the premium alone, £4,000 for a couple.

1.124 The chart below sets out the expected profile of the NLW, based on OBR forecasts.

Chart 1.12: National Minimum Wage and National Living Wage, historical and forecast



Source: HMT calculation based on OBR forecast of average hourly earnings and historical and announced National Minimum Wages.

1.125 Alongside the Budget, the government has published an entirely new remit for the LPC.[54] To ensure that the rate of the NLW is set at a sustainable level and continues to take account of

[54] [Detail].

broader economic conditions, the LPC's remit will require it to set the NLW in a way that reflects the growth in median earnings. The LPC's remit in relation to the NMW will remain unchanged.

1.126 For younger workers, the priority is to secure work and gain experience, which is already reflected in the existing NMW rate structure. In order to maximise the opportunities for younger workers to gain that experience, the NLW will only apply to workers aged 25 and over. The wages of younger workers will continue to be underpinned by the core NMW.

1.127 The government recognises that this new NLW may increase costs for some businesses. Therefore on top of other reductions in business tax, from April 2016, **the government will increase the National Insurance contributions (NICs) Employment Allowance from £2,000 to £3,000 a year**. This will help all businesses and charities, particularly smaller ones, with additional wage costs. As a result, up to 90,000 employers will see their employer NICs liability reduced to zero. When introduced in 2014, the Employment Allowance offset the NICs costs of employing 4 workers full time on the NMW. The increase in the Employment Allowance will mean firms will be able to continue to employ 4 workers full time on the new NLW next year, without paying any NICs.

1.128 The further reduction in the rate of corporation tax will also cut costs for businesses, as will reforms to the Annual Investment Allowance (set out in more detail in 'Backing business and improving productivity'). The OBR estimate that the increased cost to businesses from the NLW could amount to only just over 1% of corporate profits by 2020.

The economic impact of a National Living Wage

The concept of setting a minimum wage target based on 60% of median earnings was set out in a recent report by the Resolution Foundation, authored by the first chair of the LPC Professor Sir George Bain, along with others including Professor Alan Manning, as part of a more ambitious approach to low pay with additional focus on the longer term impacts.[4]

The introduction of a NLW will reduce the incidence of low pay and increase the returns to entering work. There may also be an increase in costs for businesses, which could affect employment. The OBR assessment of the impact of the introduction of a National Living Wage, given the continued strong employment growth seen in the UK, is to have "revised up fractionally" their forecast for unemployment rate. They estimate that even after the introduction of the new NLW, employment is forecast to rise by 1.1 million in 2021 – only 60,000 lower than it would have risen without the NLW. While some empirical studies have found reductions in employment from increases in the minimum wage, these have generally been modest.[5] Other studies have been unable to find robust evidence of any negative employment effect.[6]

Indeed, in 2001, the adult minimum wage increased by 10.8% in a single year. Further strong rises in 2003 and 2004 resulted in the minimum wage increasing by 31.1% over four years. Here, the evidence suggests that there was not a large impact on employment.

Summarising the existing research, the LPC stated in 2011 that, "The consensus of the research findings on the impact of the NMW in the UK is that it has not significantly adversely affected employment but that it may have had a small negative impact on hours." Instead firms have adjusted through other channels, by adjusting profits and pricing strategies, changing pay differentials and, in low paying sectors, boosting productivity.[7] Employers' costs are also being lowered by other measures in the Budget, including reductions in the rate of Corporation Tax, and an increase in the Employment Allowance.

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[55] 'More than a minimum', Resolution Foundation, March 2014.
[56] For example, Papps, K. and Gregg, P. (2014) and Galinda-Rueda, F. and Pereira, S. (2004).
[57] For example, Stewart, M., (2004) and Bryan et al., (2013).
[58] For example, research undertaken by *Riley, R. and C. Rosazza Bondibene, (2015)* suggests that amongst low paying firms, increases in labour costs may have been met by increases in labour productivity, associated with increases in total factor productivity.

A lower tax society: cutting taxes for working people

1.129 Alongside action on wages, the government is supporting working people by ensuring that they can keep more of the money they earn by cutting taxes.

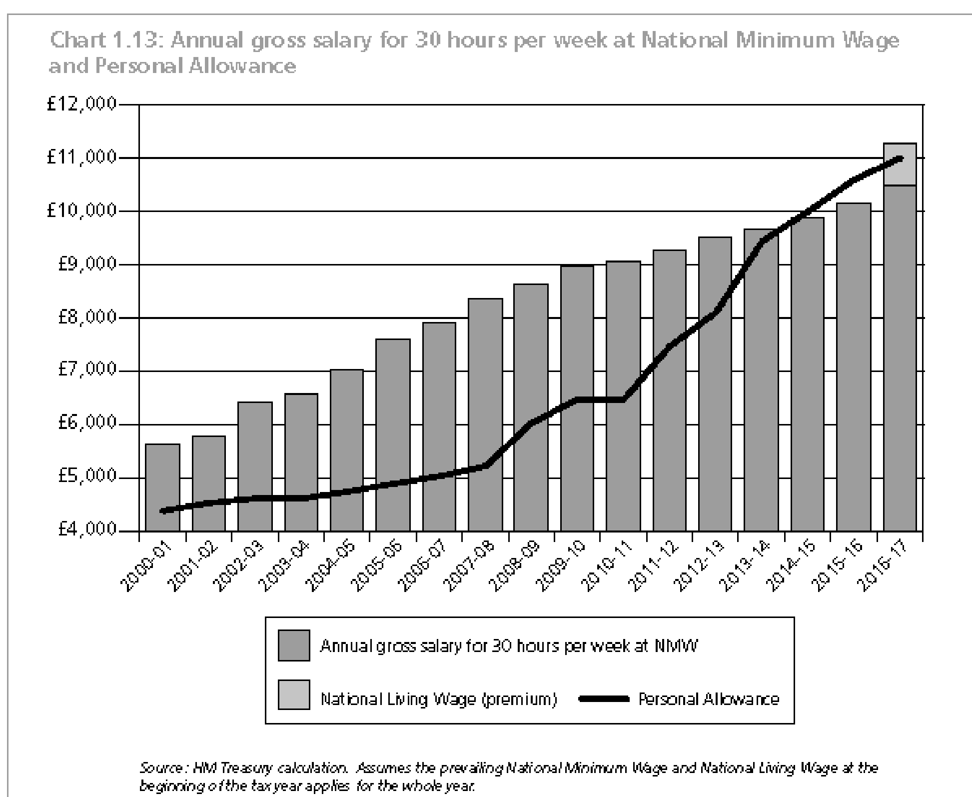
Income tax

1.130 In the last Parliament, the personal allowance increased by more than 60%, from £6,475 in 2010-11 to £10,600 in 2015-16. It is delivering a tax cut for over 27 million individuals, with basic rate taxpayers being £825 better off in 2015-16 compared with 2010. As a result, 3.8 million individuals on the lowest incomes were removed from income tax altogether, addressing the merry-go-round of taking taxes off people only to repay them in benefits.

1.131 The government wants to continue to reward work by reducing taxes and taking more people out of income tax. **The government has therefore pledged to raise the personal allowance to £12,500 by the end of this parliament.** This Budget takes the first step towards this commitment. **In 2016-17, the personal allowance will increase by £400 to £11,000.** As a result, a basic rate taxpayer will be £80 better off in 2016-17 compared to 2015-16, and £905 better off compared with 2010.

1.132 The government believes that people working 30 hours a week on the lowest pay (the NMW) should not pay income tax. **The government will therefore legislate to ensure that once the personal allowance has reached £12,500, it will always be set at least at the equivalent of 30 hours a week on the NMW.** This will ensure that those working up to 30 hours on the NMW will not pay income tax in the future.

Chart 1.13: Annual gross salary for 30 hours per week at National Minimum Wage and Personal Allowance



Source: HM Treasury calculation. Assumes the prevailing National Minimum Wage and National Living Wage at the beginning of the tax year applies for the whole year.

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1.133 The government wants to encourage those who aspire to progress in work. That is why the government has pledged to **raise the level at which the higher rate of income tax is applied, the higher rate income threshold, to £50,000 by the end of this parliament.**

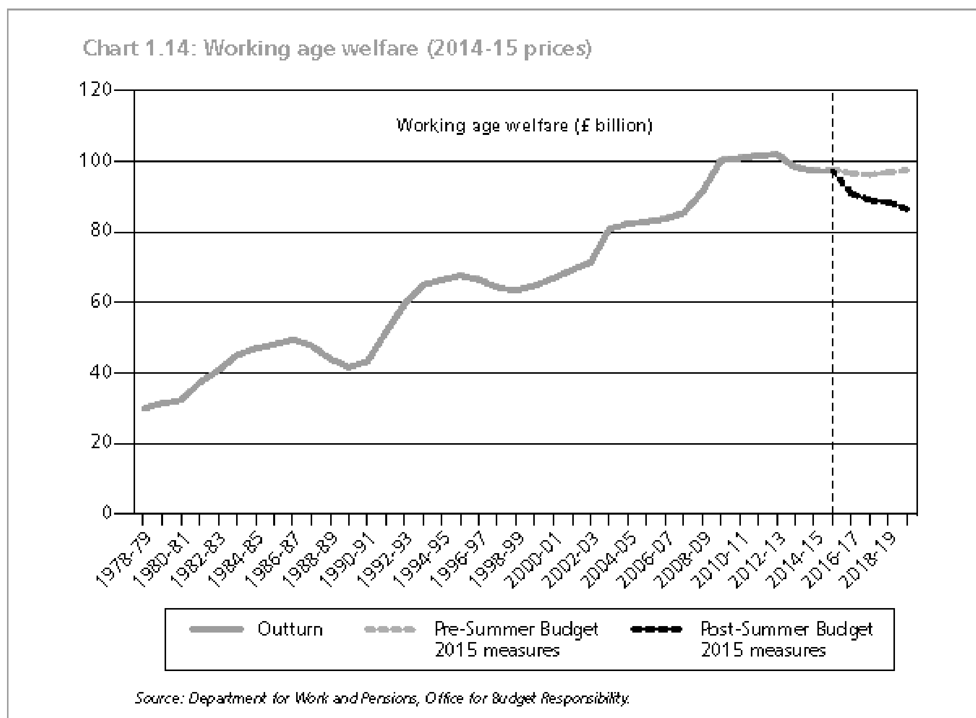
1.134 **This Budget confirms the first step towards this commitment by increasing the higher rate threshold from £42,385 to £43,000 for 2016-17.** This is the first time since 2010 that the higher rate threshold will go up by more than inflation alone. These changes will lift 130,000 individuals out of higher rate tax by 2016-17, compared to 2015-16. A typical higher rate taxpayer will benefit by £142 in 2016-17, and will be £818 better off compared to 2010.

A lower welfare society: reforming the system to make it fairer and more affordable

1.135 In the last Parliament, the government started reforming the welfare system to make it fairer and more affordable, legislating for £21 billion of savings. Universal Credit, which brings together 6 benefits into 1, represents the most fundamental reform of welfare since its inception and will mark a turning point towards a system where work will always pay more than a life on benefits. Universal Credit is due to expand to over 500 jobcentres by the end of this year.

1.136 However, despite progress during the last Parliament there is still more to do. Taxpayers are still being asked to pay for welfare expenditure that remains disproportionately high. 7% of global expenditure on social protection is spent in the UK, despite the fact that the UK produces 4% of global GDP and has only 1% of the world's population. As chart 1.14 shows, spending on working-age welfare has increased significantly in real terms over the last few decades. Too many families continue to be trapped on benefits. **The Budget sets out the next stage of welfare reform, delivering on the government's commitment to save £12 billion from the working age welfare bill.**

Chart 1.14: Working age welfare (2014-15 prices)



Source: Department for Work and Pensions, Office for Budget Responsibility.

Freezing working-age benefits

1.137 Since the financial crisis began in 2008, average earnings have risen by 11%, whereas most benefits, such as Jobseeker's Allowance, have risen by 21%. To ensure that it always pays to work, and that earnings growth overtakes the growth in benefits, **the government will legislate to freeze working-age benefits, including tax credits and the Local Housing Allowances, for 4 years from 2016-17 to 2019-20.** This is forecast to save £4 billion a year by 2019-20.

1.138 Statutory payments, including Maternity Allowance, Maternity Pay, Paternity Pay and Statutory Sick Pay will continue to be indexed by CPI. Disability benefits will also continue to be indexed by CPI, including Personal Independence Payment, Attendance Allowance, Disability Living Allowance and Employment and Support Allowance (Support Group).

1.139 The government will continue to protect benefits which are specifically for pensioners. The 'triple lock' on the State Pension will be maintained; and other benefits for pensioners including the Winter Fuel Allowance and free TV licences for over 75s will be protected in this Parliament. Pensioners have paid into the system throughout their working lives, and are the group least able to increase their income in response to welfare reform.

1.140 Alongside the freeze in working-age benefits, the government will reduce rents in social housing in England by 1% a year for 4 years, requiring Housing Associations and Local Authorities to deliver efficiency savings, making better use of the £13 billion annual subsidy they receive from the taxpayer. Rents in the social sector increased by 20% over the 3 years from 2010-11. This will allow social landlords to play their part in reducing the welfare bill. This will mean a 12% reduction in average rents by 2020-21 compared to current forecasts.

Making Tax Credits and Universal Credit fairer

1.141 Tax credit expenditure more than trebled in real terms between 1999-00 and 2010-11, with total expenditure in 2014-15 estimated to be around £30 billion – an increase of almost £10 billion in real terms over the last 10 years. UK expenditure on family cash benefits is the highest in the OECD, and was double the OECD average in 2011. 9 out of 10 families with children were eligible for tax credits in 2010. As a result of the reforms undertaken in the last Parliament, 6 out of 10 are eligible currently.

1.142 The government believes that now is the best time to address this growing expenditure if the welfare system is to be put on a sustainable footing. Tackling tax credit spending is part of properly addressing the root causes of low pay, with the new NLW and a more generous tax system to help people earn more and keep more of what they earn, rather than addressing only the symptoms of the problem by subsidising low pay through the benefit system.

1.143 The Budget will therefore reform the tax credits system (and its successor, Universal Credit) to protect existing families on the lowest incomes while favouring support to working families through the tax system and earnings growth, rather than the benefit system.

1.144 From April 2016, the government will reduce the level of earnings at which a household's tax credits and Universal Credit award starts to be withdrawn for every extra pound earned. In tax credits, this point (known as the income threshold) will be reduced from £6,420 to £3,850. The equivalents in Universal Credit (work allowances) will be reduced to £4,764 for those without housing costs, £2,304 for those with housing costs, and removed altogether for non-disabled claimants without children. **The government will also increase the rate at which a person's or household's tax credit award is reduced as they progress in work**, by increasing the taper rate in tax credits from 41% to 48%.

1.145 The Budget will also reform tax credits to make them fairer and more affordable. On top of Child Benefit for every child, an out of work family with 5 children can currently claim over £14,000 a year in tax credits alone. The government believes that those in receipt of tax credits should face the same financial choices about having children as those supporting themselves solely through work.

1.146 **The Budget will therefore limit support provided to families through tax credits to 2 children, so that any subsequent children born after April 2017 will not be eligible for further support. An equivalent change will be made in Housing Benefit to ensure consistency between both benefits. This will also apply in Universal Credit to families who make a new claim from April 2017.**

1.147 In addition, **those starting a family after April 2017 will no longer be eligible for the Family Element in tax credits. The equivalent in Universal Credit, known as the first child premium, will also not be available for new claims after April 2017. In Housing Benefit, the family premium will be withdrawn for new claims from April 2016,** to ensure fairness between those who receive Housing Benefit and those who do not.

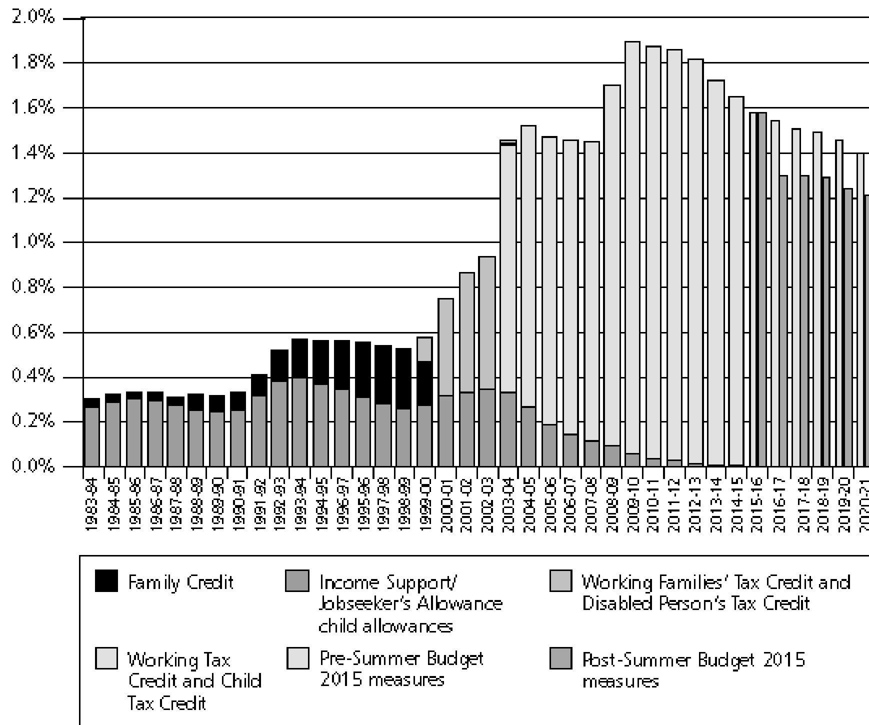
1.148 Child Benefit will continue to be paid at the same level for all children. The existing entitlement of families who remain in receipt of tax credits and Universal Credit will be unaffected by the reforms to limit support to 2 children and the abolition of the family premium. This will mean that those who already have larger families and have made plans on the basis of the current system will not lose out. The disabled child premia in tax credits and UC will also continue to be paid to all children with a disability.

1.149 These changes will see expenditure on tax credits return to 2007-08 levels in real terms. In 2016-17, 5 in 10 families with children will be supported through tax credits, down from 6 in 10 today and 9 out of 10 in 2010.[59] Chart 1.15 compares past and forecast expenditure on tax credits and predecessor benefits as a proportion of GDP, and illustrates the impact of these reforms.

1.150 Taking the welfare changes together with the introduction of the NLW and record increases in the income tax personal allowance, this will mean that 8 out of 10 working households will be better off in 2017-18 by an average of £130. A couple over 25 working full time on the NMW and who benefit from the NLW, with 2 children, will take home a higher net income by 2020-21 than they did in 2015-16. Chart 1.16 illustrates the picture across the decade.

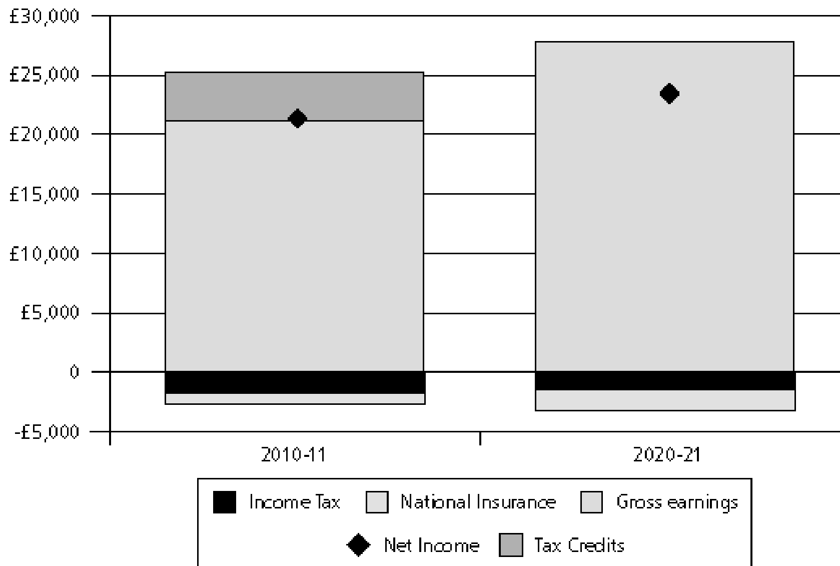
[59] HM Treasury Microsimulation Model.

Chart 1.15: Expenditure on tax credits and equivalents as a percentage of GDP



Source: HMRC, DWP, ONS.

Chart 1.16: Income of a typical household on National Minimum Wage and National Living Wage



Source: HMT calculations, OBR earnings projection. Based on a couple, both working 35 hours a week at National Minimum Wage, then National Living Wage, with 2 children, in 2010-11 prices. Assumes household does not receive housing benefit. Excludes child benefit. Includes government pledge to raise the Personal Allowance to £12,500 by 2020-21.

1.151 The table below sets out the combined impact of the Budget changes to welfare, the personal allowance and NLW on individual households. A typical renting household with two children and two full-time earners currently at the minimum wage will see their net income rise by 12% in real terms over the Parliament. Over the Parliament, a typical renting household with one child, and one adult in work currently at the minimum wage, is expected to see their net income rise by 6% in real terms, whereas the same household with no one in work is expected to see their income fall in real terms by 4%.

Table 1.8: Illustrative impact on households of personal tax, welfare and National Minimum Wage/National Living Wage changes 2010-11 to 2020-21

	net income (cash)			Change since 2015-16 (cash terms)	% change since 2015-16 (cash terms)	% change since 2015-16 (real terms)
	2010-11	2015-16	2020-21			
Dual earner family: Couple, 2 children, 2x35hrs on NLW	£24,850	£28,160	£33,730	£5,570	20%	12%
Part-time second earner: Couple, 2 children, 1st earner earns median salary, 2nd earner 16hrs on NLW	£27,020	£29,130	£35,480	£6,350	22%	14%
Single earner family: Couple, 2 children, 1x35hrs on NLW	£23,060	£26,040	£28,510	£2,480	10%	3%
Working lone parent: 1 child, 35hrs on NLW	£18,850	£21,110	£22,650	£1,550	7%	1%
Single person: no children, 35hrs on NLW	£11,560	£13,060	£15,170	£2,110	16%	9%
Out of work couple, 1 child	£15,600	£17,690	£18,030	£350	2%	-4%
Out of work couple with children, living outside London, subject to benefit cap	£28,300	£26,000	£20,000	-£6,000	-23%	-28%

Households are assumed to be renting at the average LHA rate. Benefit cap example is based on a higher rent and 3 children. Legacy benefits system is used for 2010-11 and 2015-16; UC system for 2020-21. Excludes council tax and Council Tax Benefit/Council Tax Support.
2020-21 includes the Government's ambition to raise Personal Allowance to £12,500
All working households earn the NMW (NLW in 2020-21) unless stated otherwise. Minimum wage rates used are those in effect at the beginning of the fiscal year. Individuals' earnings above the NMW/NLW are assumed to rise with average earnings.
Figures may not sum due to rounding.
Source: HM Treasury calculations, ONS earnings data, OBR earnings and inflation forecasts.

Fairness between benefit claimants and taxpayers

1.152 The government believes that those out of work should not receive more from benefits than many working families earn. Given the success of the household benefit cap in encouraging households to look for work, **the government will lower the cap on the total amount of benefits an out of work family can receive**, from £26,000 to £20,000, except in London where higher rents will be recognised through a £23,000 cap. Households subject to the cap still receive substantial support: a cap at £23,000 is equivalent to typical pre-tax earnings of around £29,000, and a cap at £20,000 is equivalent to typical pre-tax earnings of around £25,000. Those who find a job will continue to be exempt from the household benefit cap, creating a clear incentive to move into work. Exemptions will continue to apply for the most vulnerable disabled people.

1.153 To help ensure Local Authorities are able to protect the most vulnerable housing benefit claimants, **the government will provide £800 million of funding for Discretionary Housing Payments over the next 5 years**.

1.154 The government believes that those on higher incomes should not be subsidised through social rents. Therefore, **social housing tenants with household incomes of £40,000 and above in London, and £30,000 and above in the rest of England, will be required**

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to "Pay to Stay", by paying a market or near market rent for their accommodation. This will ensure they pay a fair level of rent, or make way for those whose need is greater. Local Authorities will repay the rent subsidy that they recover from high income tenants to the Exchequer, contributing to deficit reduction. Housing Associations will be able to use the rent subsidy that they recover to reinvest in new housing. This could raise up to hundreds of millions of pounds in additional rental income for Housing Associations. The government will consult and set out the detail of this reform in due course.

1.155 **The government will review the use of lifetime tenancies in social housing** to limit their use and ensure that households are offered tenancies that match their needs, and ensure the best use is made of the social housing stock.

1.156 Currently, those who receive benefits to help to pay their mortgage interest are able to do so indefinitely with no need to pay anything back. **This Budget takes action to convert the Support for Mortgage Interest scheme into a loan, so that homeowners repay the financial support they receive.**

Employment support

1.157 The government is committed to achieving full employment: it has already set out its ambition for the UK to have the highest employment rate in the G7 and will introduce a statutory duty on the government to report progress against this ambition. Achieving full employment means backing business, reforming welfare and rewarding work. But it also means ensuring that all groups in society are given the support they need to find and keep a job.

1.158 To help young people move into and get on in work, **the Budget will introduce a new Youth Obligation for 18 to 21 year olds on Universal Credit**. From April 2017, young people will participate in an intensive regime of support from day 1 of their benefit claim, and after 6 months they will be expected to apply for an apprenticeship or traineeship, gain work-based skills, or go on a mandatory work placement to give them the skills they need to move into sustainable employment.

1.159 To prevent young people slipping straight into a life on benefits, **from April 2017 the Budget will also remove the automatic entitlement to housing support for new claims in Universal Credit from 18-21 year olds who are out of work**. This will ensure young people in the benefits system face the same choices as young people who work and who may not be able to afford to leave home. There will be exemptions, including for vulnerable young people, those who may not be able to return home to live with their parents, and those who have been in work for 6 months prior to making a claim, who will continue to be able to receive housing support for up to 6 months while they look for work.

1.160 Increasing employment levels amongst people with disabilities and health conditions are a key part of the government's aim to achieve full employment. The current system creates a financial incentive to claim sickness benefits over Jobseeker's Allowance. **From April 2017, new claimants of Employment and Support Allowance (ESA) who are placed in the Work-Related Activity Group will therefore receive the same rate as those claiming Jobseeker's Allowance**, alongside additional support to help them take steps back to work. This will ensure the right incentives and support are in place for those closer to the labour market to help them make this transition when they are ready, while maintaining the extra financial support ESA provides for those in the ESA Support Group who are furthest from work. Existing ESA claimants will be unaffected.

1.161 The government will also consider where employers and insurers should play a greater role in providing support for those who suffer from industrial injuries in the workplace. The government will report at the Spending Review.

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1.162 While progress has been made in women's employment, inequalities remain – the female employment rate is around 10 percentage points lower than for men. Much of this relates to childcare: according to the 2012-13 Department for Education childcare and early years survey of parents, over half (54%) of non-working mothers agreed that they would like to go out to work if they could arrange good quality childcare that was convenient, reliable and affordable.

1.163 **This Budget confirms that, from September 2017, the free childcare entitlement will be doubled from 15 hours to 30 hours a week for working parents of 3 and 4 year olds.** This will support those who choose to go out to work. The government will implement this extension of free hours early in some local areas from September 2016. This free childcare is worth around £5,000 a year per child.[60] To support delivery, the government has committed to raise the average hourly rate providers receive and is undertaking a review of childcare costs in order to set a rate that is fair for providers and delivers value for money for the taxpayer.

1.164 The government also reaffirms its commitment to deliver Tax-Free Childcare to support parents in the decision to go out to work, or work more, and provide security for their families. As announced on 1 July, the government welcomes the Supreme Court's judgment that its proposals for delivering the scheme are clearly lawful and **Tax-Free Childcare will now be introduced from early 2017**.

1.165 In the meantime, **the government is taking action to support parents with childcare costs by holding open the existing Employer Supported Childcare scheme to new entrants until Tax-Free Childcare is launched.** Parents who wish to remain in Employer Supported Childcare once Tax-Free Childcare is launched will be able to, while their current employer continues to offer the voucher scheme. The new scheme will support up to 1.8 million working families by providing up to £2,000 of childcare support per year per child.

1.166 In the context of the extensive childcare support offered to parents of 3 and 4 year olds, the government will also change the conditions for parents claiming out of work benefits. **Parents with a youngest child aged 3 or older (including lone parents) who are able to work will be expected to look for work if they are claiming Universal Credit. These parents will receive support from Jobcentre Plus.** This is a further step in a process of reform which has helped lift the proportion of lone parent families in work to its highest level since 1996.

1.167 **The government will also provide £30 million to further speed up the adoption process** while paving the way for the introduction of regional adoption agencies.

Eliminating the deficit in a fair way

1.168 The government is committed to eliminating the deficit in a fair way, while supporting working people through the tax system and higher wages. The cornerstone of this commitment is to introduce legislation for a "tax lock" to rule out increases in the main rates of income tax, VAT and National Insurance for the duration of this Parliament, providing certainty to working people.

1.169 Instead, the government will continue to target those who evade or avoid paying taxes to ensure that all businesses and individuals make a fair contribution towards reducing the deficit. This will build on the government's crackdown on tax avoidance, aggressive tax planning and evasion over the last Parliament, which achieved £7 billion of annual savings. The government has also identified a number of imbalances in the tax system where support disproportionately benefits certain groups or types of business structure, and this Budget addresses those imbalances.

[60] HMT calculation.

Ensuring individuals and businesses pay what they owe

1.170 The majority of individuals and businesses pay their fair share of tax. However, there are some who fail to pay what they owe due to error or a failure to comply with their obligations as a taxpayer. There are also a small group who deliberately try to evade paying the tax they should.

1.171 This Budget **announces significant additional investment in HMRC's work on non-compliance and tax evasion covering a range of areas**. The government will invest £800 million over this Parliament.

1.172 This includes **tripling the number of criminal investigations that HMRC can undertake into serious and complex tax crime, focusing particularly on wealthy individuals and corporates**, with the aim of increasing prosecutions in this area to 100 a year by the end of the Parliament.

1.173 As well as announcing additional resource for the measures announced today on evasion and non-compliance, the government is committed to providing HMRC with the funding it needs to maintain its current level of compliance performance, while making efficiencies. HMRC's compliance yield targets will increase to reflect the impact of the Budget measures.

Businesses

1.174 To improve tax compliance among large businesses, **the government will introduce legislation to improve transparency of tax strategies and give HMRC new powers to tackle those businesses who persistently engage in aggressive tax planning**.

1.175 To improve tax compliance among small businesses, **the government will legislate to give HMRC the power to acquire data from online business intermediaries and electronic payment providers to help identify businesses that are trading but not declaring or paying tax**. HMRC will consult on these proposals in July 2015.

1.176 **From 8 July 2015, the government will change the tax rules to stop the use of losses against tax that should be paid through the Controlled Foreign Companies (CFC) rules.** This will improve the effectiveness of the UK CFC regime in countering aggressive tax planning by multinational companies while maintaining the overall competitiveness of the UK Corporation Tax regime.

1.177 **The government will stop investment fund managers from using tax loopholes to avoid paying the correct amount of capital gains tax (CGT) on the profits of the fund payable to them (known as carried interest).** This measure will have immediate effect by requiring taxpayers who receive carried interest to pay the full 28% CGT charge on their award. Asset managers will no longer be able to use tax planning to reduce the value of the gain. The government continues to support the asset management industry in the UK, and considers that carried interest should be subject to CGT, as it reflects the underlying long term performance of a fund's investments.

1.178 **The government will also launch a consultation on the circumstances in which fund managers' performance-related returns are to benefit from CGT treatment.** The consultation will set out and clarify the circumstances in which performance fees arising to fund managers from management activities will be capital in nature.

Employment taxes

1.179 Employment taxes contribute over 40% of HMRC receipts. However, there are many different mechanisms that employers and individuals use to reduce taxes paid on earnings. This is not fair. Two individuals doing the same job, in the same way, can end up paying very different levels of tax. The government wants to take steps to address this.

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1.180 The government recognises that many individuals choose to work through their own limited company. However, where people would have been employees if they were providing their services directly, anti-avoidance legislation commonly known as IR35 introduced in 2000 requires that they pay broadly the same tax and National Insurance as other employees. As highlighted by reports from the Office of Tax Simplification and the House of Lords, it is clear that IR35 is not effective enough. Non-compliance in this area is estimated to cost over £400 million a year.

1.181 **The government has asked HMRC to start a dialogue with business on how to improve the effectiveness of existing IR35 legislation.** The government wants to find a solution that protects the Exchequer and improves fairness in the system.

Wealthy individuals

1.182 To improve tax compliance among wealthy individuals, **the government will consult on enhancing the information reported to HMRC by wealthy individuals and trustees, and is extending HMRC's use of dedicated Customer Relationship Managers to individuals with net wealth between £10 million and £20 million.** Together, these proposals will help ensure HMRC has an in-depth understanding of wealthy individuals' tax affairs and the risks they present.

Serial offenders

1.183 For those individuals who continue to avoid paying the correct level of tax, the government will strengthen the penalty for doing so, which will also act as a wider deterrent from such activities. **The government will consult on the technical details of introducing tougher measures for those who persistently enter into tax avoidance schemes that fail, including a surcharge on those whose latest tax return is inaccurate due to use of a failed scheme and publishing the names of such avoiders.** Following the announcement at Budget 2015, **the government will also consult on the detail of a new General Anti-Abuse Rule (GAAR) penalty.** The GAAR penalty will be proportional to the amount of tax recovered by the GAAR.

Addressing imbalances in the tax system

1.184 The government has identified a number of areas of the tax system where imbalances have developed over time and where certain reliefs are disproportionately benefiting certain groups of individuals. This Budget seeks to make the tax system fairer and better at supporting a productive economy.

Individuals

Dividends

1.185 The current system of tax credits on dividends was designed over 40 years ago when corporation tax was more than 50% and the total tax bill on dividends for some was more than 80%. Since then, tax rates including corporation tax have fallen, leaving the Dividend Tax Credit as an arcane and complex feature of the tax system.

1.186 Alongside further cuts to corporation tax rates for all businesses, the government will reform and simplify the system of dividend taxation, while maintaining the extensive tax reliefs for investments held in ISAs and pensions. **From April 2016 the government will remove the Dividend Tax Credit and replace it with a new tax-free Dividend Allowance of £5,000 a year for all taxpayers.** This will ensure that ordinary investors with smaller portfolios and modest dividend income will see no change in their tax liability – and some will pay less tax.

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1.187 Combined with the increases the government has made to the personal allowance and the introduction of the Personal Savings Allowance, **from April 2016 individuals will be able to receive up to £17,000 of income per annum tax-free, and separately invest up to £15,240 per annum through an ISA tax-free.**

1.188 **The government will set the dividend tax rates at 7.5% for basic rate taxpayers, 32.5% for higher rate taxpayers and 38.1% for additional rate taxpayers.** While these rates remain below the main rates of income tax, those who receive significant dividend income – for example due to very large shareholdings (typically more than £140,000) or as a result of receiving significant dividends through a closed company – will pay more.

1.189 These changes will also start to reduce the incentive to incorporate and remunerate through dividends rather than through wages to reduce tax liabilities. This will reduce the cost to the Exchequer of future tax motivated incorporation (TMI) by £500 million a year from 2019-20. The tax system will continue to encourage entrepreneurship and investment, including through lower rates of Corporation Tax.

Landlords

1.190 The current tax system supports landlords over and above ordinary homeowners. Landlords can deduct costs they incur when calculating the tax they pay on their rental income. A large portion of those costs are interest payments on the mortgage. Mortgage Interest Relief was withdrawn from homeowners 15 years ago. However, landlords still receive the relief. The ability to deduct these costs puts investing in a rental property at an advantage. Tax relief for finance costs is particularly beneficial for wealthier landlords with larger incomes, as every £1 of finance cost they incur allows them to pay 40p or 45p less tax. The Bank of England has also noted in its recent Financial Stability Report that the rapid growth of buy to let mortgages could pose a risk to the UK's financial stability.[61]

1.191 **The government will restrict the relief on finance costs that landlords of residential property can get to the basic rate of income tax.** The restriction will be phased in over 4 years, starting from April 2017. This will reduce the distorting effect the tax treatment of property has on investment and mean individual landlords are not treated differently based on the rate of income tax that they pay. It will also shift the balance between landlords and homeowners.

1.192 The government will also reform how landlords of residential property can account for the costs they incur in improving and maintaining rental property. Currently, landlords of furnished properties can deduct 10% of their rent from their profit to account for wear and tear, irrespective of their expenditure. This means landlords can reduce their tax liability even when they have not improved the property. **From April 2016, the government will replace this allowance with a new system that enables all landlords of residential property to only deduct costs they actually incur.**

1.193 **The government will increase the Rent-a-Room relief from £4,250 to £7,500 a year from April 2016.** The value of this relief has been frozen since 1997, so this increase will allow individuals who rent a room in their main residence to do so tax free on income up to £7,500 to reflect increases in rent.

Non-domiciled individuals

1.194 Within a controlled immigration system, the government wants the UK to be a destination that will attract talented people to work and to do business. Having a tax system that is internationally competitive brings in talent and investment which contributes to the growth of the economy. The UK's rules for those who are not domiciled here are important in attracting people to live and to work here. The government remains committed to that aim.

[61] 'Financial Stability Report', Bank of England, July 2015.

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However, the government also wants the system to be fair. It believes that those who choose to live in the UK for a long time should pay taxes here like everybody else.

1.195 **From April 2017, anybody who has been resident in the UK for more than 15 of the past 20 tax years will be deemed UK-domiciled for tax purposes. Furthermore, it will no longer be possible for somebody who is born in the UK to parents who are UK domiciled to claim non-domicile status if they leave but then return and take up residency in the UK.** These changes will bring an end to the permanent non-domicile status. They create a fairer system while protecting the ability of the UK to continue to attract individuals to come to the UK to work and invest.

1.196 **From April 2017 the government will also introduce new rules so that everybody who owns residential property in the UK and would otherwise pay inheritance tax on that property cannot avoid paying it by holding it in an offshore structure.** These changes will limit abuses of the rules by people with non-domicile status who use complicated structures to make their UK homes look like offshore assets.

National Insurance contributions

1.197 Salary sacrifice arrangements can allow some employees and employers to reduce the income tax and National Insurance that they pay on remuneration. They are becoming increasingly popular and the cost to the taxpayer is rising. **The government will actively monitor the growth of these schemes and their effect on tax receipts.**

1.198 To ensure that the NICs Employment Allowance is focussed on businesses and charities that support employment, **from April 2016, companies where the director is the sole employee will no longer be able to claim the Employment Allowance.**

Businesses

1.199 The government wants a more simple tax system that enables UK businesses to compete, and this Budget sets out a number of steps to achieving this. However, a tax system that is fair for all taxpayers means ensuring a fair contribution from businesses.

Banking tax reform

1.200 While the government considers that banks and building societies should make an additional contribution to reflect their unique risks, it recognises the need to balance this with considerations around UK competitiveness and banks' ability to support the broader economy.

1.201 This Budget therefore sets out a long-term roadmap for the taxation of banks, designed to maintain this balance and take account of the very significant improvements in banking sector regulation and underlying profitability since the bank levy was first introduced. This involves three steps:

- **the introduction of a new tax on banking sector profit from 1 January 2016, set at a permanent rate of 8%**
- **a phased reduction of the bank levy rate, from the existing rate of 0.21% to 0.18% from January 2016, 0.17% from January 2017, 0.16% from January 2018, 0.15% from January 2019, 0.14% from January 2020 and 0.10% from January 2021**
- **a change in the bank levy's scope from 1 January 2021, meaning that UK headquartered banks are levied on their UK balance sheet liabilities**

1.202 This plan is forecast to increase banks' additional contribution by around £2 billion across the forecast period, helping to ensure banks make a fair contribution. However, it also sets a path towards a more competitive and sustainable model for raising revenue from the

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banking sector over the longer-term, which is a 26% rate of tax on profit – the lowest among G7 nations – and a 0.1% levy on UK balance sheet liabilities.

1.203 This means that banks' contributions will be increasingly aligned with profit and capital accumulation, reducing the risk of tax constraining lending or influencing banks' decisions on the location of internationally mobile activities. It also means that banks' contributions will be increasingly linked to activities within the UK, helping to reduce the impact of tax on the competitiveness of UK banks' overseas operations and helping to reflect the ongoing impact of regulatory reform and resolution planning in reducing the risk of these operations to the UK economy.

1.204 Finally, by allowing tax receipts to respond naturally to changes in banks' balance sheets and profitability, these changes will introduce stability into the banking tax regime and ensure that banks can incorporate tax into their business plans with greater certainty. This is reinforced by the government's decision to legislate the bank levy rate, out to and including 2020-21, in the upcoming Finance Bill.

1.205 As part of this banking tax roadmap, this Budget also announces that **relief will be provided against the UK bank levy for payments made to the Eurozone Resolution Fund**, consistent with the government's general policy on avoiding double imposition. Affected banks will be able to claim relief from 1 January 2016.

1.206 Companies are currently entitled to deduct the costs of compensation payments in calculating their profits liable for Corporation Tax. As announced at Budget 2015, **the government is legislating to make compensation payments paid by banks in relation to widespread misconduct in the sector non-deductible for Corporation Tax purposes, effective from 8 July 2015**. This is forecast to increase bank's Corporation Tax payments by around £1 billion over the next 6 years.

Insurance

1.207 The government remains committed to ensuring customers can purchase insurance at a fair price. The cost of home contents insurance has fallen by 8% since last year, and the cost of comprehensive private motor insurance has fallen by 10% in the last 3 years. The government will reform the regulation of the claims management sector to help to drive out further unnecessary costs from insurance premiums. This Budget announces a **fundamental review of the regulation of claims management companies (CMCs), led by the Chairman of the Chartered Trading Standard Institute Board Carol Brady, which will report to HM Treasury and the Ministry of Justice in early 2016**. In addition, there is also a case for reform of the fees that CMCs charge consumers, particularly in those instances where consumer complaints fall within the remit of the Financial Ombudsman Service. Therefore, **the government will bring forward proposals for the introduction of a cap on the charges that CMCs can apply to their customers, and will consult on how this will work in practice.**

1.208 This builds on the success of previous measures including the ban on referral fees and action to address fraudulent whiplash claims. The Insurance Fraud Taskforce will report by the end of 2015 on what can be done to reduce the impact of fraud on insurance premiums. To further assist car owners, the government will **extend the deadline for new cars and motorcycles to have a first MOT test from 3 years to 4**, saving motorists more than £100 million per year, subject to public consultation and cost-benefit evaluation. If people compare the different options available for their insurance they can generally get a much better deal, but many people simply renew with their existing insurer without checking the price they could get elsewhere. **The Financial Conduct Authority (FCA) will review what more can be done to ensure that people are encouraged to shop around when they renew their insurance.**

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1.209 From 1 November, the standard rate of Insurance Premium Tax will be increased from 6% to 9.5%. The Insurance Premium Tax standard rate will remain lower than that of many other EU Member States. It will, for example, continue to be much lower than the 19% tax rate that applies in Germany. **Seperately, the government will also introduce VAT provisions to level the playing field for insurers.** This will deter insurers from routing costs via offshore associates and ensure UK VAT is accounted for an all repair services on UK insurance contracts.

Corporation tax

1.210 The government will reform the corporation tax rules to stop companies claiming an annual deduction from their taxable profits for the acquisition cost of assets linked to the business' reputation and customer relationships. This is consistent with the rules in other major economies. The government continues to support company growth and expansion, and believes this will remove a distortion in the market which is artificially altering the way companies choose to expand. This change has immediate effect and will only impact future purchases of assets.

1.211 Currently, large companies in the UK pay tax in instalments, but they do not start paying tax until the seventh month of their accounting period. This means that large UK companies pay tax later than in most other G7 countries, and later than most individuals. This lag creates a cost to the Exchequer. **The government will bring forward payment dates for the largest companies in the UK – those with profits in excess of £20 million – so payments are made closer to the point when a company earns a profit. From April 2017 these companies will be required to make corporation tax payments in the third, sixth, ninth and twelfth months of their accounting period.**

Tobacco and alcohol

1.212 The consultation launched at Autumn Statement 2014 on introducing a tobacco levy has now ended. Analysis of the responses shows that the impact of a tobacco levy on the tobacco market would be similar to a duty rise, with tobacco manufacturers and importers passing the levy onto consumer prices.

1.213 HMRC analysis shows that a levy of £150 million would only raise £25 million after behavioural effects. The methodology used to calculate the impact of a levy on the public finances has been verified by Ulrike Hotopp, the Chief Economist at the Department of Environment, Food and Rural Affairs. As tobacco duties have already increased this year and will continue to increase by more than inflation each year in this Parliament, the government has decided not to introduce a levy on tobacco manufacturers and importers. The consultation responses will be published shortly.

1.214 This Budget also announces **additional resource for HMRC to tackle the organised crime gangs behind the illicit tobacco and alcohol markets.**

1.215 The government is also committed to supporting small cider makers given their important role in rural communities. **The government will retain the current duty exemption until and unless a replacement scheme is established.**

Supporting Savers

1.216 The government is committed to supporting savers at all stages of their lives to help them secure a better financial future for themselves and their family. Over the last Parliament, the government took significant action to give people greater freedom and control over their pensions, and to reduce taxes for savers. This Budget continues this support by ensuring that people can pass on assets built up over their lifetime to their family without worrying about inheritance tax, and that people have access to high quality advice to help make financial decisions.

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Inheritance tax

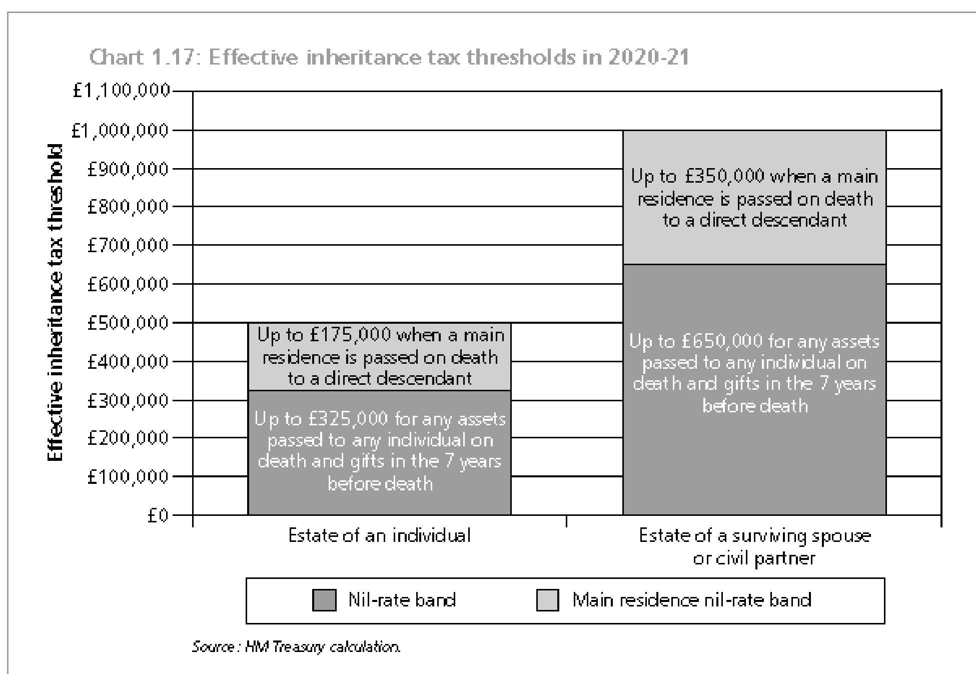
1.217 The government understands that people aspire to build up assets with the aim of passing them on to the next generation in their family, and believes that working families should be able to pass on those assets to their children and grandchildren without needing to worry about inheritance tax. Only the very wealthiest in our society should be asked to pay tax on the assets built up over their lifetime.

1.218 However, rising house prices are contributing to nearly double the number of estates facing an inheritance tax bill by 2020-21. 63,000 estates are forecast to have a tax liability in 2020-21, which is more than at any time since inheritance tax was introduced. **The government's reforms will reduce the number of estates forecast to have a tax liability in 2020-21 to 37,000, around the same levels as in 2014-15.**

1.219 The government will achieve this by **taking the family home out of inheritance tax for all but the wealthiest with a new transferable nil-rate band, introduced from April 2017. This will apply when a main residence is passed on death to direct descendants, such as a child or grandchild. The allowance will be up to £100,000 in 2017-18, up to £125,000 in 2018-19, up to £150,000 in 2019-20, and up to £175,000 in 2020-21**. This is in addition to the inheritance tax nil-rate band, which is set at £325,000 for the estates of individuals. This creates an effective £500,000 inheritance tax threshold for estates in 2020-21. As with the current nil-rate band, any unused main residence nil-rate band will be transferred to a surviving spouse or civil partner and **means the effective inheritance tax threshold will rise to £1 million** in 2020-21.

1.220 The new main residence nil rate band will also be available when a person downsizes or ceases to own a home on or after 8 July 2015 and assets of an equivalent value, up to £175,000 in 2020-21, are passed on death to direct descendants. For example, an individual might choose to downsize from a home worth £200,000 to a home worth £100,000. They could still benefit from the maximum allowance of £175,000 in 2020-21 if they leave the home and £75,000 of other assets to direct descendants. They will only be liable to inheritance tax if the total estate exceeds £500,000. The new thresholds are illustrated in chart 1.17.

Chart 1.17: Effective inheritance tax thresholds in 2020-21



Source: HM Treasury calculation.

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1.221 To ensure that the wealthiest estates continue to make a greater contribution to inheritance tax receipts, **there will be a tapered withdrawal of the main residence nil-rate band for estates with a net value of more than £2 million. The existing nil-rate band will also remain at £325,000 from 2018-19 until the end of 2020-2021**. This ensures the effective inheritance tax threshold will be up to £1 million by the end of the Parliament. The number of estates making a contribution to inheritance tax or its predecessor will continue to be higher at the end of the decade than in any year between its introduction and 2014-15. The chart below illustrates the number of estates liable for inheritance tax and cash receipts.

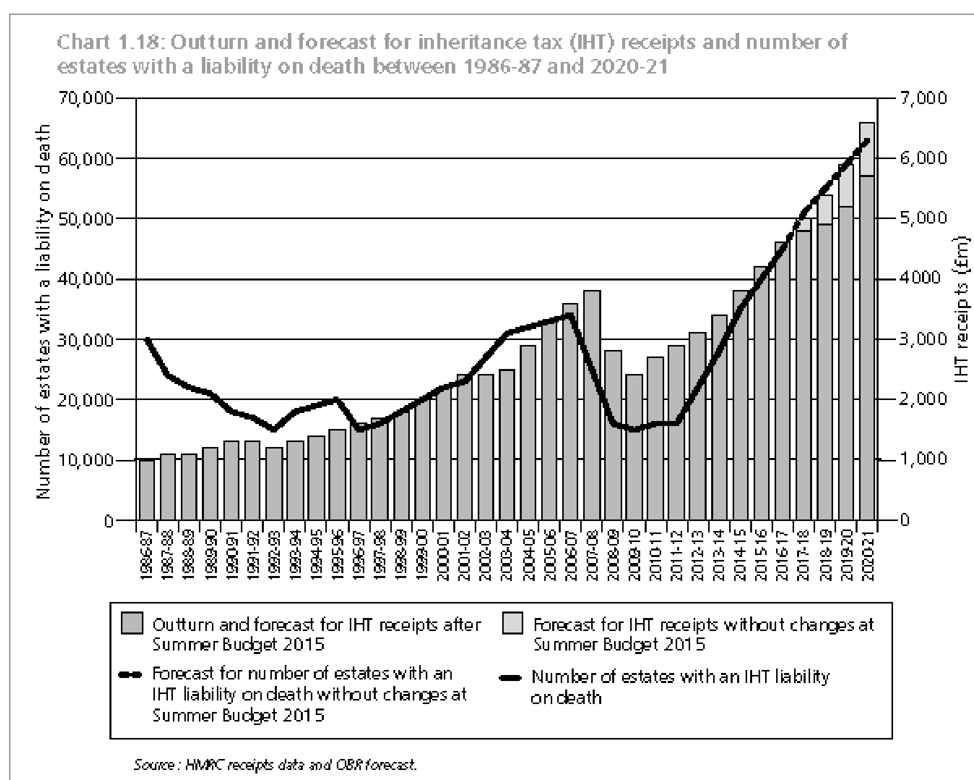

Chart 1.18: Outturn and forecast for inheritance tax (IHT) receipts and number of estates with a liability on death between 1986-87 and 2020-21

Source: HMRC receipts data and OBR forecast.

Pensions tax

1.222 To pay for the reforms to inheritance tax and to control the cost of pensions tax relief in the short term the government needs to make sure that the support provided to pension savers is affordable and targeted where it is needed most.

1.223 **Therefore, from April 2016 the government will introduce a taper to the Annual Allowance for those with adjusted annual incomes, including their own and employer's pension contributions, over £150,000.**[62] For every £2 of adjusted income over £150,000, an individual's Annual Allowance, the limit on the amount of tax relieved pension saving that can be made by an individual or their employer each year, will be reduced by £1, down to a minimum of £10,000.

1.224 To ensure this measure is focussed on the higher and additional rate tax payers who currently gain the most benefit from pensions tax relief, those with income, excluding pension contributions, below a £110,000 threshold will not be subject to a Tapered Annual Allowance.

[62] 'Adjusted income' includes taxable earnings and all pension contributions, but does not include charitable contributions.

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Only 1% of taxpayers exceed this threshold and save into pensions, and even fewer will actually be affected by this measure.

1.225 The government also wants to make sure that the right incentives are in place to encourage saving into pensions in the longer term. **The government is therefore consulting on whether there is a case for reforming pensions tax relief** to strengthen incentives to save, offering savers greater simplicity and transparency, or whether it would be best to keep the current system. The government is interested in views on the various options that have been suggested for how the system could be reformed. These range from a fundamental reform of the system (for example moving to a system which is "Taxed-Exempt-Exempt" like ISAs and providing a government top-up on pension contributions) to less radical changes (such as retaining the current system and altering the lifetime and annual allowances), as well as options in between.

1.226 Any reform to pensions tax relief would build on the reforms to the pension and savings tax systems announced in the last Parliament, which have already given individuals greater freedom with their money and flexibility over how they hold their savings.

Pension and savings flexibilities

1.227 Over 85,000 people have taken advantage of the new flexibilities for accessing pensions that were introduced in April 2015. The government believes it is important that all consumers can access free, high quality guidance on their choices. **Following the successful launch of Pension Wise in April 2015, the government is extending access to this free and impartial guidance service to those aged 50 and above, and is launching a comprehensive nationwide marketing campaign to further raise awareness of the service.**

1.228 The government also wants to ensure that people can access the new flexibilities easily, and at reasonable cost. **The government will consult before the summer on options aimed at making the process for transferring pensions from one scheme to another quicker and smoother, including in relation to any excessive early exit penalties.** If there is evidence of such penalties, the government will consider imposing a legislative cap on these charges for those aged 55 or over.

1.229 The government wants existing annuity holders to have the freedom to sell their annuity income. The government will set out plans for a secondary annuities market in the autumn, and agrees with respondents to the recent consultation that implementation should be delayed until 2017 to ensure there is an in-depth package to support consumers in making their decision.

1.230 The government is committed to supporting savers at every stage of their life. From April 2016 the government will deliver a major reduction in the level of tax on savings with the introduction of the Personal Savings Allowance, which will exempt the first £1,000 of savings income from tax for basic rate taxpayers and the first £500 for higher rate taxpayers, and as detailed above, this Budget announces the creation of a new £5,000 dividend allowance.

Help to Buy: ISA

1.231 To help as many people as possible realise their aspirations of home ownership, the Help to Buy: ISA was announced at Budget 2015. This supports people saving up for their first home by providing them with a maximum government bonus of £3,000 on £12,000 of savings. **The government is today announcing that Help to Buy: ISAs will be available for first time buyers to start saving into from 1 December 2015.** First time buyers will be able to deposit £200 per month into their Help to Buy: ISA at participating banks and building societies. **First time buyers will be able to open their Help to Buy: ISA accounts with an additional one off deposit of £1000 so that they can start saving now.**

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Equitable Life Payment Scheme

1.232 The Equitable Life Payment Scheme, which began making payments in 2011, has paid out over £1 billion to around 87% of eligible policyholders. The government is announcing today that **the Equitable Life Payment Scheme will close to new claims on 31 December 2015**. As part of this, the government will undertake a further effort to trace remaining policy holders due £50 or more. With Profits Annuitants will continue to receive annual payments under the Scheme for their lifetimes. **This Budget also announces that eligible policyholders in receipt of Pension Credit will see their lump sum payment doubled, with payments made in early 2016.**

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